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RAILROAD ANTITRUST ENFORCEMENT ACT OF 2009

HEARING

BEFORE THE

SUBCOMMITTEE ON COURTS AND
COMPETITION POLICY

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

H.R. 233

MAY 19, 2009

Serial No. 111–63

Printed for the use of the Committee on the Judiciary

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CONTENTS

MAY 19, 2009

Page

THE BILL

H.R. 233, the "Railroad Antitrust Enforcement Act of 2009" 3

OPENING STATEMENTS

The Honorable Henry C. "Hank" Johnson, Jr., a Representative in Congress from the State of Georgia, and Chairman, Subcommittee on Courts and Competition Policy 1

The Honorable Howard Coble, a Representative in Congress from the State of North Carolina, and Ranking Member, Subcommittee on Courts and Competition Policy 10

The Honorable Lamar Smith, a Representative in Congress from the State of Texas, and Ranking Member, Committee on the Judiciary 11

WITNESSES

The Honorable Rodney Alexander, a Representative in Congress from the State of Louisiana
  Oral Testimony 12
  Prepared Statement 15

Mr. M. Howard Morse, Chair, Exemptions and Immunities Committee, American Bar Association, Section of Antitrust Law, Washington, DC
  Oral Testimony 18
  Prepared Statement 21

Mr. J. Michael Hemmer, Vice Chairman, Policy and Advocacy Committee, Association of American Railroads, Washington, DC
  Oral Testimony 35
  Prepared Statement 44

Mr. Terry Huval, Director, Lafayette Utilities System, Lafayette, LA
  Oral Testimony 74
  Prepared Statement 76

Dr. Mark N. Cooper, Director of Research, Consumer Federation of America, Washington, DC
  Oral Testimony 87
  Prepared Statement 90

APPENDIX

Material Submitted for the Hearing Record 109

RAILROAD ANTITRUST ENFORCEMENT ACT OF 2009

TUESDAY, MAY 19, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COURTS AND
COMPETITION POLICY
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3 p.m., in room 2141, Rayburn House Office Building, the Honorable Henry C. "Hank" Johnson, Jr. (Chairman of the Subcommittee) presiding.

Present: Representatives Conyers, Johnson, Wexler, Jackson Lee, Watt, Sherman, Coble, Goodlatte, and Harper.

Also present: Representatives Scott and Smith.

Staff present: Anant Raut, Majority Counsel.

Mr. JOHNSON. This hearing of the Committee on the Judiciary's Subcommittee on Courts and Competition Policy will now come to order. Without objection, the Chair is authorized to declare a recess.

Today's hearing is about H.R. 233, a bill that would eliminate antitrust exemptions in the railroad industry. The bill would enable the Department of Justice and the Federal Trade Commission to enforce antitrust laws in the railroad industry. The bill would also restore the full range of antitrust rights and remedies to private parties.

Under the Interstate Commerce Commission, and later the Surface Transportation Board, the number of class one railroads in this country shrank from 63 to 7. As of now, four of the class ones handle 90 percent of the Nation's rail carrier traffic, two to the East and two to the West.

The effect of this consolidation has been an increase in prices. According to an October 2006 GAO study, the volume of traffic traveling at significantly noncompetitive rates has increased since 1985. The rates paid by so-called "captive shippers," that is shippers with only one carrier option, on part of that route are, on average, almost 21 percent higher than on competitive routes, costing shippers an additional $1.3 billion every year.

These costs are ultimately passed on to consumers as higher prices. They mean higher prices at the dealership for the cars transported by rail. They mean higher prices at the grocery store for the crops shipped by rail, et cetera, et, cetera, et cetera.

As a matter of public policy, we shy away from antitrust exemption. The Antitrust Modernization Commission, created by this

Committee, made the following observation about exemption: "Antitrust exemptions create economic benefits that flow to small groups while the costs are usually passed on to a large population of consumers though higher prices, reduces output, lower quality, and reduced innovation."

The bill before us today would leave the rail carrier industry no differently situated than any other number of industries subject to both antitrust laws as well as regulation. It would, however, remove antiquated antitrust exemptions favoring the industry, which will spur innovation, drive down costs, and ultimately lower prices for consumers.

[The bill, H.R. 233, follows:]

I

111TH CONGRESS
1ST SESSION

H. R. 233

To amend the Federal antitrust laws to provide expanded coverage and to eliminate exemptions from such laws that are contrary to the public interest with respect to railroads.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 7, 2009

Ms. BALDWIN (for herself, Mr. POMEROY, Mr. ALEXANDER, and Mr. WALZ) introduced the following bill; which was referred to the Committee on the Judiciary, and in addition to the Committee on Transportation and Infrastructure, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

---

A BILL

To amend the Federal antitrust laws to provide expanded coverage and to eliminate exemptions from such laws that are contrary to the public interest with respect to railroads.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Railroad Antitrust Enforcement Act of 2009".

SEC. 2. APPLICATION OF THE ANTITRUST LAWS TO RAIL COMMON CARRIERS.

(a) APPLICATION OF THE ANTITRUST LAWS.—The antitrust laws shall apply to a common carrier by railroad that is subject to the jurisdiction of the Surface Transportation Board under subtitle IV of title 49, United States Code, without regard to whether such common carrier filed a rate or whether a complaint challenging a rate is filed.

(b) DEFINITION.—The term "antitrust laws" has the meaning given it in subsection (a) of the 1st section of the Clayton Act (15 U.S.C. 12(a)), but includes section 5 of the Federal Trade Commission Act to the extent such section 5 applies to unfair methods of competition.

SEC. 3. MERGERS AND ACQUISITIONS OF RAILROADS.

The last undesignated paragraph of section 7 of the Clayton Act (15 U.S.C. 18) is amended by inserting "(excluding transactions described in section 11321 of title 49 of the United States Code)" after "Surface Transportation Board".

SEC. 4. ANTITRUST ENFORCEMENT AUTHORITY.

Section 11(a) of the Clayton Act (15 U.S.C. 21(a)) is amended by inserting "(excluding agreements described in section 10706 of such title and transactions described in section 11321 of such title)" after "Code".

SEC. 5. INJUNCTIONS AGAINST RAILROAD COMMON CARRIERS.

The proviso in section 16 of the Clayton Act (15 U.S.C. 26) is amended by inserting "(excluding a common carrier by railroad)" after "Board".

SEC. 6. REMOVAL OF PRIMARY JURISDICTION AS LIMITATION.

The Clayton Act (15 U.S.C. 12 et seq.) is amended by adding at the end thereof the following:

"SEC. 29. In any civil action against a common carrier railroad under section 4, 4A, 4C, 15, or 16, the district court shall not be required to defer to the jurisdiction of the Surface Transportation Board.".

SEC. 7. UNFAIR METHODS OF COMPETITION.

Section 5(a)(2) of the Federal Trade Commission Act (15 U.S.C. 45(a)(2)) is amended by adding at the end the following:

"For purposes of this paragraph with respect to unfair methods of competition, the term 'common carrier' excludes a common carrier by railroad that is subject to jurisdiction of the Surface Transportation Board under subtitle IV of title 49 of the United States Code.".

SEC. 8. TERMINATION OF EXEMPTIONS IN TITLE 49.

(a) IN GENERAL.—Section 10706 of title 49, United States Code, is amended—

(1) in subsection (a)—

(A) in the 3d sentence of paragraph (2)(A) by striking ", and the Sherman Act (15 U.S.C. 1 et seq.)," and all that follows through "or carrying out the agreement",

(B) in paragraph (4)—

(i) by striking the 2d sentence, and

(ii) in the 3d sentence by striking "However, the" and inserting "The", and

(C) in paragraph (5)(A) by striking ", and the antitrust laws set forth in paragraph (2) of this subsection do not apply to parties and other persons with respect to making or carrying out the agreement",

(2) in subsection (d) by striking the last sentence, and

(3) by striking subsection (e) and inserting the following:

"(e) Nothing in this section exempts a proposed agreement described in subsection (a) from the application of the antitrust laws (as defined in subsection (a) of the 1st section of the Clayton Act, but including section 5 of the Federal Trade Commission Act to the extent such section 5 applies to unfair methods of competition).

"(f) In reviewing any proposed agreement described in subsection (a), the Board shall take into account, among any other considerations, the impact of the proposed agreement on shippers, consumers, and affected communities. The Board shall make findings regarding such impact, which shall be—

"(1) made part of the administrative record;

"(2) submitted to any other reviewing agency for consideration in making its determination; and

"(3) available in any judicial review of the Board's decision regarding such agreement.".

(b) COMBINATIONS.—Section 11321 of title 49, United States Code, is amended—

(1) in subsection (a)—

(A) by striking "The authority" and inserting "Except as provided in sections 4, 4A, 4C, 15, and 16 of the Clayton Act, the authority"; and

(B) in the 3d sentence by striking "is exempt from the antitrust laws and from all other law," and inserting "is exempt from all other law (except the laws referred to in subsection (c)),", and

(2) by adding at the end the following:

"(c) Nothing in this subchapter exempts a transaction described in subsection (a) from the application of the antitrust laws (as defined in subsection (a) of the 1st section of the Clayton Act, but including section 5 of the Federal Trade Commission Act to the extent such section 5 applies to unfair methods of competition). The preceding sentence shall not apply to any transaction relating to the pooling of railroad cars approved by the Surface Transportation Board or its predecessor agency pursuant to section 11322.

"(d) In reviewing any transaction described in subsection (a), the Board shall take into account, among any other considerations, the impact of the transaction on shippers and affected communities.".

(c) CONFORMING AMENDMENTS.—

(1) HEADING.—The heading for section 10706 of title 49, United States Code, is amended to read as follows: "**Rate agreements**".

(2) ANALYSIS OF SECTIONS.—The analysis of sections of chapter 107 of such title is amended by striking the item relating to section 10706 and insert the following:

"10706. Rate agreements.".

SEC. 9. EFFECTIVE DATE.

(a) IN GENERAL.—Except as provided in subsection (b), this Act and the amendments made by this Act shall take effect on the date of enactment of this Act.

(b) LIMITATION.—A civil action under section 4, 4A, 4C, 15, or 16 of the Clayton Act, or a complaint under section 5 of the Federal Trade Commission Act (15 U.S.C. 45) to the extent such section 5 applies to unfair methods of competition, may not be filed with respect to any conduct or activity that—

(1) occurs before the expiration of the 180-day period beginning on the date of enactment of this Act; and

(2) was exempted from the antitrust laws (as defined in subsection (a) of the 1st section of the Clayton Act (15 U.S.C. 12(a)), but including section 5 of the Federal Trade Commission Act (15 U.S.C. 45) to the extent such section 5 applies to unfair methods of competition) by an order of the Interstate Commerce Commission or the Surface Transportation Board issued before the date of the enactment of this Act and pursuant to law.

○

Mr. JOHNSON. I now recognize my colleague, Howard Coble, the distinguished Ranking Member of this Subcommittee for his opening remarks.

Mr. COBLE. Thank you, Mr. Chairman. And I appreciate your having called today's hearing. Last year, Mr. Chairman, the full Committee approved similar legislation by voice vote. I have not changed my views on the impact that shipping costs have on many industries in the district I represent, many of which provide essential services; but as I did not serve on the Antitrust Task Force last session, I appreciate this opportunity to more closely review H.R. 233 and to discuss its impact, as you have just done.

My concern with the rail shipping industry and hope for today's hearing is that we approve the most effective solution. Perhaps antitrust review by the Justice Department or FTC is the most effective solution, although are needed improvements at the Service Transportation board, known as the STB.

And a visit back down memory lane, in an antiquated way, Mr. Chairman, in 1887 the Congress passed the Interstate Commerce Act, which established the Interstate Commerce Commission. That body was in charge of regulating virtually every facet of the railroad's operations, including the rates that they charged customers to ship goods across the country.

Congress' regulation of the railroads began at about the same time as it passed the Sherman Antitrust Act. As the two laws developed over time, the courts and the Congress recognized that heavily regulated industries, such as railroads, should not be subject to the full reach of the antitrust laws. The courts developed the so-called "filed rate," or Keogh Doctrine, to shield railroads from antitrust liability for rates that were set through a regulatory body, and the Congress statutorily exempted certain pooling arrangements from antitrust security.

Over time, the Nation's attitude toward heavy regulation changed, particularly as some heavily regulated industries, including the railroads, began to suffer. By 1980, the rail industry had become glaringly inefficient, and as a result, the Congress passed the Staggers Act, which deregulated the industry and shortly thereafter replaced the Interstate Commerce Commission with the STB.

Currently the STB is not required to approve shipping rates, and the rail industry is not covered by the antitrust laws, which is why the Justice Department can not independently challenge rail mergers. This authority rests solely with the STB and is at the heart of H.R. 233 and today's hearing.

Many shippers who also claim to be captive to unjustified rates and rigid schedules argue that there are instances where shipping from other countries can be more cost effective than shipping within two points in the United States. Meanwhile, we all know the benefit of railroads. They are energy efficient; they can move massive amounts of goods; and they are, indeed, a driving force in our sagging economy.

I have heard from constituents back in my district, Mr. Chairman, about this issue. I want to help solve the problem, but feel very strongly that we should understand how H.R. 233 will affect the rail industry. While I am here with an open mind, in my view the onus today and moving forward is on the rail industry to help us identify problems and to recommend solutions or improvements to H.R. 233.

That said, I look forward to today's testimony and yield back the balance of my time, and thank you again, Mr. Chairman, for having called the hearing.

Mr. JOHNSON. Thank you, Ranking Member Coble.

I thank the gentleman for his statement, and I now recognize John Conyers, a distinguished Member of the Subcommittee and the Chairman of the Committee on the Judiciary, should he wish to make a statement.

He has said, "Good afternoon." And is there anyone else who wishes to make a statement for the record?

The Honorable Lamar Smith, the Ranking Member of the full Committee?

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Chairman, let me begin by saying that I appreciate the concerns of the shipping industry. Like many others in the economy, they are suffering. Rising costs mean that when their existing long-term contracts for the shipment of coal expire, for example, some power companies in my district will face drastically higher rates from the railroads.

While I am sympathetic and concerned about the plight of the captive shippers, I am also concerned that the legislation before us will not necessarily solve their problem. The bulk of the shippers' concerns seem to lie with what they view as an ineffectual regulatory body, the Surface Transportation Board, or STB.

Like the members of the Antitrust Modernization Commission, I am skeptical about many antitrust exemptions. To me, the elimination of some antitrust exemptions for the railroad industry, such as subjecting mergers in the industry to review before the antitrust division of the Department of Justice, makes sense.

However, the Railroad Antitrust Enforcement Act of 2009 does more than just that. It would subject railroads to search for injunctive relief throughout the country. Because railroads are widespread networks that are not easily diverted into other channels, an injunction in one part of the network could have serious repercussions throughout.

In addition, a railroad that runs across multiple districts and circuits, as most do, could be subject to an injunction in one district, whereas the exact same conduct could be deemed "not problematic" just one district over. Worse still, discrepancies among district circuit courts may lead to form shopping by aggressive plaintiff lawyers, which is something that has created problems in the class action arena before.

Another issue raised by this bill is the provision that specifies that Federal district courts do not have to defer to the discretion of the Surface Transportation Board in these suits. As it is currently worded, this provision, which is inconsistent with generally accepted principles of administrative law, is likely to encourage judges to be overly reluctant to refer suits that would most appropriately be handled by the Surface Transportation Board to that regulatory body.

Finally, I am concerned that the section of the bill that provides for a grace period for civil suits after the enactment of the bill may actually invite courts to look retroactively into practices that were exempted from the antitrust laws or were specifically approved by the STB at the time they occurred. I am worried that in an effort to address the shippers' concerns about bottleneck pricing and paper barriers courts may be tempted to undo mergers that were approved years ago. Such unscrambling of the eggs is something that is generally discouraged in antitrust law.

Mr. Chairman, I appreciate the issues that bring us here today. I am hopeful that this hearing will give us the opportunity to consider the concerns that I have with this legislation. And I am also hopeful that we will be able to come up with solutions that will address the shippers' concerns without ruining our vital railroad infrastructure or undermining widely and long held aspects of regulatory law and practice. And with that I will yield back.

Mr. JOHNSON. I thank the gentleman for his statement, and without objection, other Members' opening statements will be included in the record.

I am now pleased to introduce the witnesses at today's hearing. On our first panel is the Honorable Rodney Alexander. Congressman Alexander proudly represents the Fifth District of the great southern State of Louisiana. He is also an original cosponsor of the legislation we have before us today.

Congressman Alexander, will you proceed please?

TESTIMONY OF THE HONORABLE RODNEY ALEXANDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. ALEXANDER. Thank you, Mr. Chairman. First thing I would like to do is thank you and the Ranking Member for allowing me the opportunity to be here today and to thank the full Committee for hearing this bipartisan bill that attempts to level the playing field out there today.

I would like to be clear, in starting, that this bill is not about reregulation of the railroad industry. The bill does nothing of the sort. It simply places the rail industry under the same antitrust laws that every other industry, such as energy, telecommunications, or even other forms of freight transportation, including trucking and aviation, places. These laws, of course, are the Nation's basic laws for ensuring competitive markets.

As you know, Mr. Chairman, 30 years ago the railroad industry was failing and Congress removed much of the regulatory oversight over the industry, and merger authority was transformed to the industry's only regulator, the Surface Transportation Board. Unfortunately, at that time Congress did not remove the antitrust exemptions from the industry that had accumulated through various acts of Congress and the courts during the 1900's.

Since 1980, the railroad industry has been able to use the antitrust exemptions that they still currently enjoy to consolidate over 40 major class one railroads into four major carriers that today carry 90 percent of our Nation's rail freight. The problem that this poses is that freight rail customers are subject to abusive practices without the protection of our Nation's antitrust laws.

This problem is now evident not only to consumers but to the Department of Justice as well. In her Senate nomination hearings, Christine Varney, who is now the chief antitrust enforcer at the Justice Department, recognized the need for competition in the rail industry when she stated that she enthusiastically supports the bill that we are debating today.

Shippers continue to report skyrocketing rates and unreliable service. Louisiana is the second largest chemical manufacturing state in the Nation. As such, the chemical industry provides significant economic benefits to the state and to the Nation as a whole.

I think it is important to remind ourselves that over 96 percent of all manufactured goods are directly touched by the business of chemistry, making the industry an essential part of every facet of Louisiana and the national economy. But these businesses do not see the railroads as a reliable source of transportation, especially when you compare that service to the rates they are forced to pay.

The chemical companies are not alone. Utility companies are being forced to raise the cost of electricity provided to the businesses and households that they serve. On the next panel, Terry Huval, the director of utilities for the city of Lafayette, will testify concerning a bottleneck that prevents a large coal-fired electricity generating plant near Boyce, Louisiana, called the Rotomaker Plant, from gaining access to competitive coal transportation rates for over 95 percent of the length of a coal haul from Wyoming.

An organization known as the Louisiana Energy and Power Authority also receives electricity from the Rotomaker Plant and distributes it to six towns in my congressional district: Alexandria, Jonesville, New Roads, Plaquemine, Vidalia, and Winnfield. The citizens, businesses, and schools in these towns are facing a cost of captivity that is similar to the cost that Terry will describe for the city of Lafayette.

In 2004, the Bush administration Department of Justice wrote the Chairman of this Committee, indicating that the bottleneck ruling that is causing these high transportation costs that my constituents are paying likely violates the antitrust laws, if those laws applied here.

Unfortunately, until this Congress enacts H.R. 233, the railroads will remain exempt from and beyond the reach of the Nation's antitrust laws. I want to see my constituents relieved of this cost of captivity through the enactment of this legislation, of which I am proud to be a lead cosponsor of my political party with Congresswoman Tammy Baldwin.

Coal-fired electric generating stations serving citizens across our Nation are facing similar problem. Recently, in Florida, the CSX Railroad, which is the sole source of transportation of coal from the Appalachians to Seminole Electric Co-op, doubled its rate for coal shipments to Seminole. Seminole states that this rate hike will cost its electricity consumers an additional $100 million annually beginning in 2009.

American manufacturing, agriculture, timber, and paper companies that are all facing rising rates that they are forced to attempt to pass on to their consumers at a time when their customers can't afford the cost of these increases. While these rate hikes don't work for most Americans and most businesses, the hikes have served the freight rail industry well, as can be seen by the returns of the four major freight railroads in the fourth quarter of 2008. These four railroad companies each posted earning increases on decreased volumes of traffic moved. Unfortunately, few if any of their consumers—their customers—could report such a positive economic performance.

Congressman Baldwin, Congressman Pomeroy, Congressman Walsh, and I introduced this bill to level that playing field. First, the railroad antitrust exemption that has no current public policy jurisdiction and is protecting anticompetitive conduct for the railroad industry. Second, the bill permits the Justice Department and the FTC to review railroad mergers, line sales, and other railroad transactions under the antitrust law standard to ensure competitive markets.

Third, the bill ensures that the regulatory program developed by the Surface Transportation Board will be pro-competitive. And finally, the bill allows the state attorney general and other private parties to sue for damages and for injunctions to halt anticompetitive conduct, both of which are currently allowed due to the railroad industry's exemptions from the antitrust laws.

In March of this year, the Senate Judiciary Committee passed unanimously by a vote of 14 to zero bipartisan legislation very similar to this. Some have argued that his legislation would result in overlapping dual regulation by antitrust courts and the STB; but in fact, they would not be overlapping nor would the conflict.

Rail transportation that is subject to STB jurisdiction is the only major Federal regulated activity that operates outside the U.S. antitrust laws. All other U.S. industry activities that are subject to Federal economic regulation are also subject to the antitrust laws that protect consumers from monopolization, agreements in restraint of trade, and mergers that may lessen competition.

While the bill is by no means the final solution for restraining railroad monopoly power, the enactment of the bill would be a giant step forward in that direction.

Again, I thank you, Mr. Chairman, for allowing me to testify in support of this legislation, and I look forward to working with the Committee as we move forward with this legislation. Thank you.

[The prepared statement of Mr. Alexander follows:]

PREPARED STATEMENT OF THE HONORABLE RODNEY ALEXANDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Testimony of Rep. Rodney Alexander

Railroad Antitrust Enforcement Act of 2009, H.R. 233

Judiciary Committee
Subcommittee on Courts and Competition Policy

May 19, 2009

I would like to thank the Chairman and Ranking Member for granting me the opportunity to testify before this subcommittee. I would also like to thank the entire committee for considering HR 233, the Railroad Antitrust Enforcement Act of 2009. This bipartisan legislation is crucial to leveling the playing field by providing competition to the rail industry.

I would like to be clear in stating that this bill is not about "reregulation" of the railroad industry. The bill does nothing of the sort. It simply places the rail industry under the same antitrust laws that every other industry such as energy, telecommunications, or even other forms of freight transportation, including trucking and aviation, faces. These laws, of course, are the nation's basic laws for ensuring competitive markets.

As you know Mr. Chairman, thirty years ago the railroad industry was failing and Congress removed much of the regulatory oversight over the industry and merger authority was transferred to the industry's only regulator, the Surface Transportation Board. Unfortunately at that time Congress did not remove the antitrust exemptions that the industry had accumulated through various acts of Congress during the 1900s. Since 1980, the railroad industry has been able to use the antitrust exemptions that they still currently enjoy to consolidate over 40 major Class 1 railroads into four major carriers that today carry 90% of our nation's freight rail.

The problem that this poses is that freight rail customers are subject to abusive practices without the protection of our nation's antitrust laws. This problem is now evident not only to consumers, but to the Department of Justice as well. In her Senate nomination hearings, Christine Varney, who is now the chief antitrust enforcer at the Justice Department, recognized the need for competition in the rail industry when she stated that she did support this bill.

Shippers continue to report skyrocketing rates and unreliable service. Louisiana is the second largest chemical manufacturing state in the nation. As such, the chemical industry provides significant economic benefits to the state and to the nation as a whole. I think it's important to remind ourselves that over 96% of all manufactured goods are directly touched by the business of chemistry, making this industry an essential part of every facet of the Louisiana and national economy, but these businesses do not see the railroads as a reliable source of transportation especially when you compare that service to the rates they are forced to pay.

The chemical companies are not alone. Utility companies are being forced to raise the cost of electricity provided to the businesses and households that they serve. Recently in Florida, the railroads have doubled its charges to ship coal. It is estimated that this rate hike will cause consumers to pay an additional $100 million in 2009. This is also happening in manufacturing, agriculture, timber and paper companies that are all facing rising rates that they are forced to pass on to their consumers.

These high rate hikes can be seen in the earnings that are being reported by the railroad industry. The earnings posted for the final quarter, October through December of 2008, report revenues are up, while volume in fact has decreased.

Representative Tammy Baldwin has introduced HR 233, the Railroad Antitrust Enforcement Act of 2009 to level the playing field in the railroad industry by doing the following

First, it eliminates the antiquated railroad antitrust exemption that has no current public policy justification and is protecting anticompetitive conduct by the railroad industry.

Second, the bill permits the Justice Department and the FTC to review railroad mergers under the antitrust law standard to ensure competitive markets.

And finally, the bill allows state Attorneys General and other private parties to sue for damages and to halt anticompetitive conduct, both of which are not currently allowable under federal law.

In March of this year, the Senate Judiciary Committee unanimously passed this same legislation by a vote of 14 – 0.

Some have argued that this legislation would result in overlapping dual regulation by antitrust courts and the STB, but in fact they would not be overlapping nor would they conflict. This legislation would only treat railroads like every other industry in the U.S.

Rail Transportation that is subject to STB jurisdiction is the only major federal regulated activity that operates outside of U.S. antitrust laws. All other U.S. industry activities that are subject to federal economic regulation are also subject to the antitrust laws that protect consumers from monopolization, agreements in restraint of trade, and mergers that may lessen competition. This should also be the same for the railroad industry.

While this bill is by no means the final solution in perfecting the railroad industry, it is a giant step forward in the right direction. It is not an attack on railroad companies, it is simply a necessary measure in ensuring a level playing field for all.

Again, I thank you Mr. Chairman for allowing me to testify in support of this important piece of legislation and I look forward to working with you and all the members of the committee as we hope to move forward toward full consideration of this bill this year.

Mr. JOHNSON. Thank you, Congressman Alexander. The Subcommittee appreciates you being with us today.

And we will now turn to our second panel and ask them to take their seats here at the table. And while they are doing that I will introduce them.

First we have Mr. Howard Morse. Mr. Morse is a partner at the law firm Drinker Biddle & Reath. Before joining the firm, Mr. Morse spent 10 years at the Federal Trade Commission, where he served as assistant director of the bureau of competition. Mr. Morse is here today on behalf of the American Bar Association's section of antitrust law and he is currently chair of the section's exemptions and immunities committee.

Next is Mike Hemmer——

And by the way, Mr. Morse, welcome today.

Next is Mike Hemmer, Vice Chairman of the Policy and Advocacy Committee of the Association of American Railroads. In addition to his position with AAR, Mr. Hemmer is a Senior Vice President and general council of Union Pacific Railroad. Prior to his appointment, Mr. Hemmer was a partner in the Washington, D.C. office of Covington & Burling, specializing in transportation law.

Welcome, sir.

Next we have Mr. Terry Huval, director of Lafayette Utilities System, located in Lafayette, Louisiana—or is it Lafayette?

Mr. HUVAL. Lafayette.

Mr. JOHNSON. Lafayette. Okay. LUS is a municipally-owned utility providing electric water and waste water services to over 60,000 customers.

Finally, we have Dr. Mark Cooper. Dr. Cooper is director of research at the Consumer Federation of America. He has provided expert testimony in over 200 cases for public interest clients, including state attorneys general and citizen interveners for state and Federal agencies, courts and legislatures in the United States and Canada.

Thank you for being here, Dr. Cooper.

And I appreciate all of you all's willingness to participate in today's hearing. Without objection, your written statement will be placed into the record, and we would ask that you limit your oral remarks to 5 minutes. You will note that we have a lighting system here, right on the table in front of you. Nobody ever complies with it. [Laughter.]

But we are asking you to do so.

You will note that at 4 minutes the little light turns yellow, and then at 5 minutes it goes red. After each witness has presented his testimony, Subcommittee Members will be permitted to ask questions subject to the 5-minute limit.

Mr. Morse, please begin your testimony.

Sir, if you would put on your mic?

TESTIMONY OF M. HOWARD MORSE, CHAIR, EXEMPTIONS AND IMMUNITIES COMMITTEE, AMERICAN BAR ASSOCIATION, SECTION OF ANTITRUST LAW, WASHINGTON, DC

Mr. MORSE. Chairman Johnson, Congressman Coble, Members of the Subcommittee, my name is Howard Morse. I am an antitrust partner here in Washington with Drinker Biddle & Reath. As your introduction indicated, I also serve as chair of the Exemptions and Immunities Committee of the American Bar Association's Section of Antitrust Law, and I am testifying today on behalf of the Section.

The Antitrust Section appreciates the opportunity to be here and express support for H.R. 233, the Railroad Antitrust Enforcement Act, which would dismantle antitrust exemptions that insulate the railroad industry from antitrust actions. The Section Council has approved this position. Our testimony has not been reviewed, however, by the ABA House of Delegates or Board of Governors, and so I speak only for the section.

The Section believes that statutory exemptions and immunities from the antitrust laws should be strongly disfavored. Competition has proven time and again to lead to lower prices, better quality and service, and more innovation.

For more than a century, the antitrust laws have effectively promoted competition, consumer welfare, and efficient markets. Indeed, the Supreme Court, in a 1972 opinion by Justice Marshall, called the antitrust laws the Magna Carta of free enterprise, as important to the preservation of economic freedom and our free enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms.

The antitrust laws encourage firms to compete aggressively. They permit collaborations that generate pro-competitive efficiencies. But they prohibit conduct that excludes rivals to the detriment of consumers, collusion among competitors, and mergers that lessen competition.

The Section of Antitrust Law has frequently noted its opposition to antitrust exemptions based on claims that immunity is needed because of unique characteristics of particular industry. The section has opposed exemptions in industries from baseball, to health care, to ocean shipping. Claims that an antitrust exemption is necessary for competition to flourish, or because competition is itself harmful or undesirable, or that competition does not work in an industry, or that an immunity is necessary in order to provide an industry with certainty and predictability to encourage investment should not prevail.

The 2007 report of the congressionally-mandated Antitrust Modernization Commission, which was already mentioned today, similarly advises that statutory immunities from the antitrust laws should be disfavored. They should be granted rarely, and only where and for so long as is necessary.

The Section of Antitrust Law believes it is time to repeal exemptions adopted in an era that considered protection of particular industries to be beneficial. It is the Section's view that even if antitrust exemptions may have made some sense in a regulated environment, deregulation of the railroad industry has eroded the basis for continuing exemptions.

Antitrust enforcement is all the more important where there may be uncertainty as to whether activity is subject to regulation. While the railroad industry today is not immune from all antitrust actions, the industry does benefit from express statutory and judicially-created immunity, which would be eliminated by the Railroad Antitrust Enforcement act.

Even after the act becomes law, of course, the implied immunity doctrine will prevent antitrust from imposing obligations that conflict with regulation. The act would, however, among other things, remove railroads from the protection of the judicially-created "filed rate" or Keogh Doctrine, which insulates firms from antitrust damages actions.

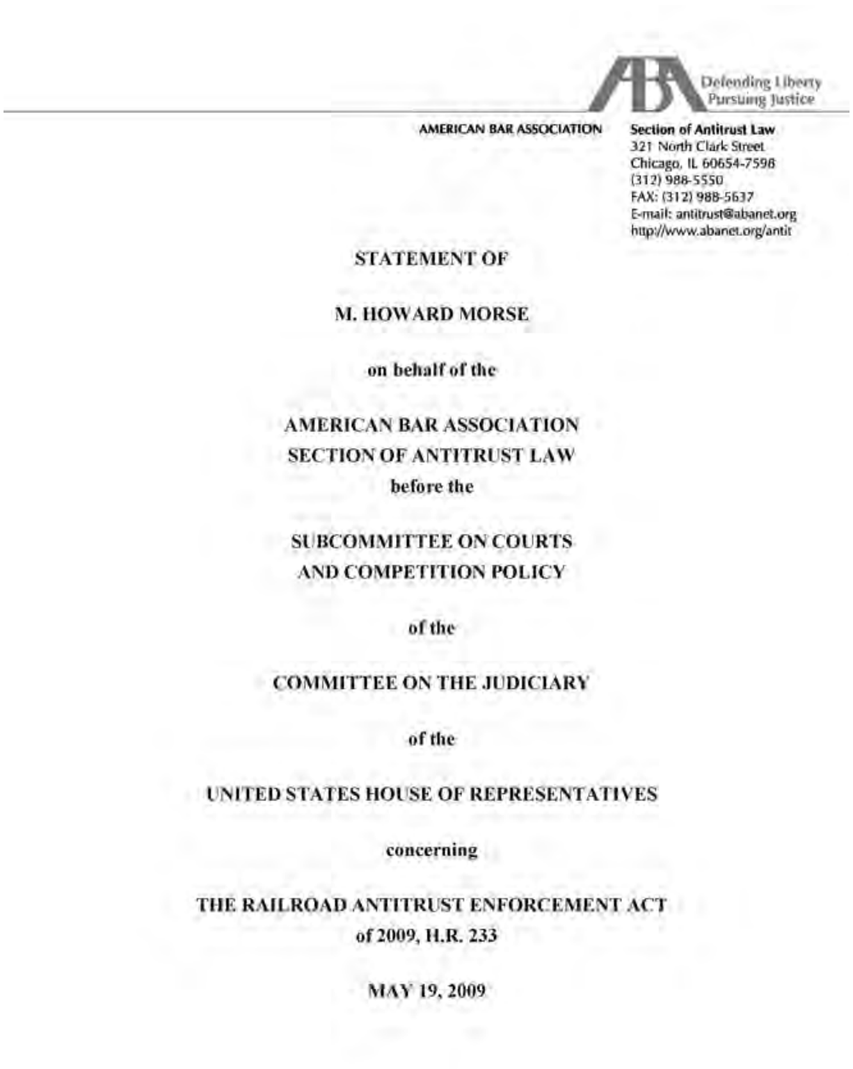
The act would also allow private parties to seek injunctive relief against railroads. So-called "bottleneck rates" and "paper barriers," or tying arrangements and exclusive dealings, would be subject to scrutiny, as in other industry, but whether they would be unlawful would depend upon the facts in the particular situation.

The act would also bring railroad mergers within the ambit of Section 7 of the Clayton Act and empower the Department of Justice and Federal Trade Commission to block acquisitions which lessen competition, as the agencies can even in other regulated industries.

The Section of Antitrust Law supports these steps. I thank you for your time and welcome your questions.

[The prepared statement of Mr. Morse follows:]

PREPARED STATEMENT OF M. HOWARD MORSE



Defending Liberty
Pursuing Justice

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STATEMENT OF

M. HOWARD MORSE

on behalf of the

AMERICAN BAR ASSOCIATION
SECTION OF ANTITRUST LAW
before the

SUBCOMMITTEE ON COURTS
AND COMPETITION POLICY

of the

COMMITTEE ON THE JUDICIARY

of the

UNITED STATES HOUSE OF REPRESENTATIVES

concerning

THE RAILROAD ANTITRUST ENFORCEMENT ACT
of 2009, H.R. 233

MAY 19, 2009

Mr. Chairman and members of the Subcommittee. My name is Howard Morse, and I am an antitrust partner in the Washington, D.C. office of Drinker Biddle & Reath LLP. I also chair the Exemptions & Immunities Committee of the Section of Antitrust Law of the American Bar Association ("the Section") and I have been authorized to testify on behalf of the Section.

The Section appreciates the opportunity to testify concerning legislation to eliminate exemptions from the antitrust laws, and is pleased to submit its views regarding the Railroad Antitrust Enforcement Act of 2009, H.R. 233. That bill is identical to the bill reported favorably by the House Judiciary Committee on September 18, 2008, which was the subject of written comments submitted by the Section to the Antitrust Task Force, the Judiciary Committee, and Speaker Pelosi and Minority Leader Boehner on December 10, 2008.

The views expressed in the Section's comments and in this testimony were approved by the Council of the Section of Antitrust Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Summary

The Section submits that any decision to allow an immunity or exemption from the antitrust laws should be made reluctantly and only after thorough consideration of each particular situation. The inquiry with respect to immunities and exemptions should focus narrowly on the fundamental principles and objectives of antitrust law, namely promoting competition and consumer welfare. Exemptions and immunities should be recognized as decisions to sacrifice competition and consumer welfare, and should accordingly be authorized only when some countervailing value – such as free speech or federalism – outweighs the general presumption in favor of competitive markets.

The Section has frequently noted its opposition to industry-specific exemptions from the antitrust laws based on claims that such immunity is necessary given unique market conditions, believing that the antitrust laws are sufficiently flexible to account for particular market circumstances. The Section's general opposition to exemptions and immunities was endorsed by the 2007 report of the Congressionally-mandated Antitrust Modernization Commission ("AMC"), which concluded that "statutory immunities from the antitrust laws should be disfavored," "[t]hey should be granted rarely" and "only where, and for so long as . . . is necessary to satisfy a specific societal goal that trumps the benefit of a free market to consumers and the U.S. economy in general."

The Railroad Antitrust Enforcement Act would remove railroads from the protection of the judicially-created "filed-rate" or *Keogh* Doctrine, which insulates firms from antitrust damages actions, and allow private parties to seek injunctive relief against railroads under the antitrust laws. The Act would also place review of railroad industry mergers, like those in other industries, in the hands of the Federal antitrust agencies – the Department of Justice ("DOJ") and the Federal Trade Commission ("FTC") – removing the exclusive authority of the Surface Transportation Board ("STB").

The Section supports these steps and encourages Congress to move forward quickly to dismantle the antitrust exemption for the railroad industry, through the Railroad Antitrust Enforcement Act, and to consider additional legislation to eliminate antitrust exemptions applicable to other industries.

I. The Section of Antitrust Law Discourages Statutory Exemptions and Immunities

The Section of Antitrust Law believes that the economy is best served by promoting competition in the marketplace, and statutory immunities and exemptions from the antitrust laws should be strongly disfavored. The Section has frequently noted its opposition to antitrust exemptions and immunities, whether created judicially or by statute, finding them to be rarely justified. The Section recently expressed this view in comments to the Federal Trade Commission:

> The Section has long and consistently resisted the creation or expansion of exemptions that shield whole areas of market activity or sectors of commerce from rigorous antitrust enforcement. The antitrust laws are designed to provide general standards of conduct for the operation of our free enterprise system, and in the Section's considered view, special exemptions from these standards rarely are justified. Whatever their expressed purposes, antitrust exemptions often impair consumer welfare.

Comments of ABA Section of Antitrust Law on FTC Report on the State Action Doctrine, at 2-3 (May 6, 2005).[1]

The Section believes that the common law process through which the antitrust laws promote both allocative efficiency and consumer welfare is flexible and evolutionary. It adapts to the unique circumstances of markets and industries, to changing technologies and circumstances, and to the development and growth of legal and economic theory.[2] The antitrust laws today do not prohibit the vast bulk of business conduct, including competitor collaborations that generate pro-competitive efficiencies or that have not harmed or are not likely to harm the competitive process and consumer welfare. They do prohibit, however, mergers that are likely to raise price or reduce quality, service or innovation, naked collusion among competitors to fix prices or allocate territories, and conduct that excludes rivals to the detriment of consumers.

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[1] The Section of Antitrust Law has supported repeal of antitrust exemptions in testimony before the Antitrust Modernization Commission, and has opposed other exemptions. *See* Comments to the Antitrust Modernization Commission on General Immunities and Exemptions, the Shipping Act Antitrust Exemption and the McCarran-Ferguson Act and Reports of the Section of Antitrust Law on the Free Market Antitrust Immunity Reform Act of 1999, the Quality Health-Care Coalition Act of 1999, Antitrust Health Care Advancement Act of 1997, the Television Improvement Act of 1977, the Major League Baseball Antitrust Reform Act of 1997, the Curt Flood Act of 1996, and the Major League Baseball Antitrust Reform Act of 1995 (all available at www.abanet.org/antitrust).

[2] *See, e.g., Nat'l Soc'y of Prof'l Eng'rs* v. *United States*, 435 U.S. 679, 687-88 (1978) ("Congress, however, did not intend the text of the Sherman Act to delineate the full meaning of the statute or its application in concrete situations. The legislative history makes it perfectly clear that it expected the courts to give shape to the statute's broad mandate by drawing on common-law tradition.").

Exemptions and immunities shelter industries or forms of behavior from the procompetitive reach of the antitrust laws, and thus are likely to harm the economy by reducing competitiveness and efficiency. They also often freeze in place the development of economic theory. Claims that an exemption or immunity is necessary for competition to flourish or because competition is itself harmful or undesirable, or does not work in some particular industry should not prevail. Over a century of development has shown that the antitrust laws are the best guardian of competition, and are capable of growing to accommodate the unique characteristics of particular industries. The antitrust laws have been described as "the Magna Carta of free enterprise . . . as important to the preservation of economic freedom and our free enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms."[3]

The Section of Antitrust Law recognizes that exemptions and immunities are occasionally warranted – but only where an important value unrelated to competition, such as free speech or federalism, trumps the need for competition. As the Section noted to the AMC, "[a]ntitrust, while vigilant regarding every nuance of competition, deliberately turns a blind eye to concerns outside that scope."[4] Thus, the *Noerr-Pennington* doctrine, developed to protect free speech and the right to petition the government, and the state action doctrine, based on the values of federalism and state sovereignty, epitomize exemptions founded upon important interests unrelated to competition. Certainly, the legislature may determine that, in a particular case, competition and the free-market system may be limited to advance some other purpose.

Antitrust exemptions for the railroad industry – and other long-standing exemptions and immunities – do not appear to be justified by any non-competition related value. Instead, they appear to be no more than "naked economic protectionism," adopted in a legal era that considered economic protectionism in certain industries to be socially beneficial – before the consensus antitrust policy that has largely governed antitrust enforcement in recent decades. It is now appropriate to re-evaluate whether statutory immunities and exemptions are consistent with promoting efficiency and consumer welfare.[5]

The Section believes that these exemptions have survived as long as they have because their benefits apply to small, concentrated interest groups that receive substantial benefits – such as railroads, ocean shipping carriers and agricultural cooperatives. On the other hand, the costs from such statutory exemptions are generally passed on to individual consumers. Thus, statutory exemptions from the antitrust laws create an asymmetry of costs and benefits. It is consumers that suffer the most from higher prices, lower output, reduced quality and reduced innovation.[6] While some shippers may complain about railroad industry practices that they allege violate the antitrust laws, consumers are the biggest losers.

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[3] *United States v. Topco Associates, Inc.*, 405 U.S. 596, 610 (1972).

[4] Comments of the ABA Section of Antitrust Law on General Immunities and Exemptions to the Antitrust Modernization Commission at 3 (Nov. 30, 2005). *See also Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 695 (1978) ("The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services. 'The heart of our national economic policy long has been faith in the value of competition.'") (quoting *Standard Oil Co. v. FTC*, 340 U.S. 231, 248).

[5] Comments of the ABA Section of Antitrust Law on General Immunities and Exemptions to the Antitrust Modernization Commission at 6-7 (Nov. 30, 2005).

Courts have generally construed exemptions to the antitrust laws narrowly, respecting Congress's desire "to strike as broadly as [possible] in § 1 of the Sherman Act."[7] While Congress of course remains free to exempt behavior from the reach of the antitrust laws, the Section of Antitrust Law believes the onus of an exemption's ongoing justification ought to be on those favoring its preservation and the Section has supported including a sunset provision in any new exemption.[8]

That there should be a presumption against antitrust exemptions is particularly true where an industry is being deregulated, and there is uncertainty as to whether activity is exempted from regulation and is shielded from the antitrust laws. If anything, activities exempted from regulation should become subject to antitrust scrutiny even if potentially subject to re-regulation. Thus, the Section of Antitrust Law supports repeal of remaining antitrust exemptions for the railroad industry, completing the industry's transition to competition.

II. The Antitrust Modernization Commission Recommends Dismantling Exemptions

The Antitrust Modernization Commission Act of 2002[9] mandated the formation of a blue-ribbon Commission appointed by the President and majority and minority leadership of the House of Representatives and the Senate. The AMC was tasked with reviewing the country's antitrust laws to determine whether and how they should be modernized.

The AMC, in 2007, reported that the economic principles that guide antitrust law remain relevant to and appropriate for the antitrust analysis of industries in which innovation, intellectual property and technological change are central features. Properly interpreted, the antitrust laws promote innovation and dynamic efficiency as well as price competition, serving consumer welfare in the global, high-technology economy that exists today.[10]

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[6] *Id.* at 4-6.

[7] *Goldfarb v. Virginia State Bar*, 421 U.S. 773, 787 (1975). One leading judge has argued: "[An antitrust exemption is] special interest legislation, a single-industry exception to a law designed for the protection of the public. When special interests claim that they have obtained favors from Congress, a court should ask to see the bill of sale. . . . [Because] special interest legislation enshrines results rather than principles . . . courts read exceptions to the antitrust laws narrowly, with beady eyes and green eyeshades." *Chicago Prof'l Sports v. Nat'l Basketball Ass'n*, 961 F.2d 667, 671-72 (7th Cir. 1992).

[8] *See* ABA Antitrust Section Amended Comments on the Shipping Act Antitrust Exemption at 3 (Mar. 17, 2006); Comments of the ABA Section of Antitrust Law on General Immunities and Exemptions to the Antitrust Modernization Commission at 11-17 (Nov. 30, 2005).

[9] Pub. L. No. 107-273, § 11054(h), 116 Stat. 1856, 1857 (2002).

Nonetheless, there are numerous industry-specific areas where Congress has explicitly stated that the antitrust laws do not apply. Statutory exemptions exist for everything from anti-hog-cholera serum to sports broadcasting. The Section of Antitrust Law has chronicled these exemptions in a monograph entitled *Federal Statutory Exemptions from Antitrust Law* (2007).

During the course of the AMC study, the Commission invited comment and held several days of hearings addressing exemptions. The AMC report advised:

> Statutory immunities from the antitrust laws should be disfavored. They should be granted rarely, and only where, and for so long as, a clear case has been made that the conduct in question would subject the actors to antitrust liability and is necessary to satisfy a specific societal goal that trumps the benefit of a free market to consumers and the U.S. economy in general.[11]

The AMC urged that even "[w]hen the government decides to adopt economic regulation, antitrust law should continue to apply to the maximum extent possible, consistent with that regulatory scheme [and] antitrust should apply whenever regulation relies on the presence of competition or the operation of market forces to achieve competitive goals."[12]

The AMC specifically concluded that no immunity should be granted to stabilize prices in order to provide an industry with certainty and predictability for purposes of investment or solvency – one of the arguments sometimes made in the railroad industry based on its need for capital investment. The AMC noted that the costs of price stability typically fall on consumers, resulting in inflexibility that undermines economic growth. Arguments that carriers need an antitrust exemption to adopt practices such as sharing equipment given the costs of investments was also specifically rejected by the AMC.[13]

III. Antitrust Exemptions in the Railroad Industry

A. Deregulation and the Role of the Surface Transportation Board

Railroads today benefit from several antitrust exemptions and immunities which are legacies of a bygone era. The AMC advised that "[d]uring the early part of the twentieth century, a belief that certain industries [such as railroads] were either 'natural' monopolies . . . or were at risk for 'excessive competition' led to government regulation of prices, costs, and entry into those industries."[14] Thus, instead of relying on antitrust laws to prevent unfair competition, regulatory agencies were given responsibility for monitoring competition. For more than a hundred years, under the Interstate Commerce Act of 1887, the Interstate Commerce Commission ("ICC") and later the Surface Transportation Board regulated the railroad industry. Technological changes and recognition of the costs and market distortion of economic regulation, however, have led to changes over time.[15]

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[10] AMC, *Report and Recommendations* (2007) (hereafter *AMC Report*).

[11] *Id.* at 335, Recommendation 57.

[12] *Id.* at 338, Recommendation 63.

[13] *Id.* at 351-52.

The antitrust exemptions in the railroad industry derive from the Transportation Act of 1920 under which the ICC developed a plan for consolidation,[16] and the Reed-Bulwinkle Act of 1948 (passed over President Truman's veto), under which the ICC approved rate bureaus.[17] Even if, in a regulated environment where all rates were subject to oversight, antitrust exemptions may have made some sense, deregulation has eroded the basis for continuing exemptions. Pervasive regulation of the railroad industry has been eliminated over the last 30 years. In 1976, Congress passed the Railroad Revitalization and Regulatory Reform Act (the "4R Act"), which reduced rate regulation and provided carriers with some flexibility in setting rates.[18] The 1980 Staggers Rail Act further limited the authority of the ICC, to regulate rates only for traffic where insufficient competition existed to protect shippers.[19] The 1995 Interstate Commerce Commission Termination Act replaced the ICC with the STB and further deregulated the industry.[20]

The STB today has limited statutory authority, *inter alia*, to resolve railroad rate and service disputes involving traffic that is subject to the agency's jurisdiction and to review railroad restructuring transactions, including line sales, line constructions and line abandonment. In addition, the agency oversees mergers between railroads.[21] Under the ICC's and the STB's administration and approval, however, the number of large (or Class I) U.S. railroads has dropped from sixty-three to seven, through a series of mergers over the past four decades and the agency's stewardship of competition has been challenged.[22]

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[14] *Id.* at 333.

[15] *Id.*

[16] Ch. 91 § 407, 41 Stat. 456, 482 (1920).

[17] Ch. 491, 62 Stat. 472 (1948).

[18] Pub. L. No. 94-210, 90 Stat. 31 (1976).

[19] Pub. L. No. 96-448, 94 Stat. 1895 (1980).

[20] Pub. L. No. 104-88, 109 Stat. 803 (1995).

[21] 49 U.S.C. § 11324.

[22] Testimony of Charles D. Nottingham, Chairman, Surface Transportation Board, before the Senate Judiciary Committee, Subcommittee on Antitrust, Competition Policy and Consumer Rights (Oct. 3, 2007).

B. Statutory and Judicially-Created Exemptions and Immunities for Railroads

While the railroad industry today is not immune from all antitrust actions, the industry does benefit from several express statutory and judicially-created immunities from antitrust law, which would be eliminated by the Railroad Antitrust Enforcement Act. Specifically, the industry today benefits from the following antitrust exemptions:

- Mergers and acquisitions are exclusively within the purview of the STB. If approved by the STB, they are exempt from challenge under Section 7 of the Clayton Act.[23]

- The STB is also authorized to review line sales, and its approval immunizes the transaction from the antitrust laws.[24]

- Certain STB-approved agreements relating to leases, trackage rights, pooling arrangements, and agreements to divide traffic, are exempted from the antitrust laws to the extent necessary to carry out the approved agreement.[25]

- Railroads are also immune for certain rate-related agreements approved by the STB, such as agreements establishing rules governing charges that one railroad must pay to use another's equipment.[26]

- Private parties may not obtain injunctive relief under the antitrust laws against a common carrier subject to STB jurisdiction.[27]

- Conferences among railroads, shippers, labor, consumer representatives and government agencies may be convened by the Secretary of Transportation, and discussions or agreements entered into with the Secretary's approval through these conferences are exempted from antitrust laws.[28]

- The STB and not the FTC has authority to enforce compliance with the Federal Trade Commission Act against railroads and other common carriers subject to STB jurisdiction.[29]

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[23] 49 U.S.C. § 11321(a).

[24] 49 U.S.C. § 10901(c).

[25] 49 U.S.C. § 10706; 15 U.S.C. § 18.

[26] 49 U.S.C. § 10706.

[27] 15 U.S.C. § 26.

[28] 49 U.S.C. § 333.

[29] 15 U.S.C. § 21(a).

- Under the judicially-created *Keogh* doctrine,[30] railroads are immune from treble damages for filed rates.

The Railroad Antitrust Enforcement Act would eliminate these exemptions and place railroads on an equal footing with most other industries.

IV. The Railroad Antitrust Enforcement Act

The Railroad Antitrust Enforcement Act would make a number of specific changes to current law to limit existing antitrust immunities applicable to the freight railroad industry. It would amend the Clayton and Federal Trade Commission Acts, as well as various sections of the federal transportation code (Title 49), to eliminate most of the antitrust exemptions and immunities that now apply to the freight railroad industry. The House bill would:

- Make railroad mergers and acquisitions subject to Section 7 of the Clayton Act;
- Amend Section 16 of the Clayton Act to allow private parties to seek injunctive relief against railroads in federal courts under the antitrust laws;
- Add a new section to the Clayton Act providing that district courts would no longer be required to defer to the primary jurisdiction of the STB in civil actions against a common carrier railroad;
- Amend Section 11(a) of the Clayton Act to remove the STB's exclusive jurisdiction over rate agreements and mergers involving railroads;
- Amend Section 5 of the FTC Act to make railroads subject to its provisions;
- Amend the Clayton Act to overturn the "filed-rate" or *Keogh* Doctrine, and allow treble damages actions against railroads for antitrust violations; and
- Make conforming amendments to the STB statute to remove antitrust exemptions for rate agreements and exclusive jurisdiction for the STB over railroad mergers and acquisitions.

Thus, while some rail shipments are already subject to the antitrust laws – because they are either under private contracts or exempted from regulation – the proposed legislation would extend antitrust coverage to the remaining freight rail traffic.

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[30] *Keogh v. Chicago & N.W. Ry. Co.*, 260 U.S. 156 (1922). *See also AMC Report, supra* note 10, at 340 ("At the time this doctrine was created, members of a regulated industry were typically required to file their proposed rates with regulators who reviewed the rates to ensure they were 'fair and reasonable.' In creating the doctrine in *Keogh*, the Supreme Court explained that only the relevant regulatory authority could change these rates, even if the rate was higher than it otherwise would be due to a price fixing conspiracy.").

A. Jurisdiction over Mergers and Acquisitions

Importantly, the Railroad Antitrust Enforcement Act would bring railroad mergers within the ambit of Section 7 of the Clayton Act and empower the Federal antitrust enforcement agencies to sue to block acquisitions, the effect of which may be substantially to lessen competition.[31] That change would be consistent with the AMC's recommendation that "even in industries subject to economic regulation, the antitrust agencies generally should have full merger enforcement authority under the Clayton Act."[32] The AMC recognized that the Department of Justice and Federal Trade Commission regularly examine mergers and acquisitions notified pursuant to the Hart-Scott-Rodino Act to determine whether such proposed transactions may substantially lessen competition, and the agencies apply the same standards to all industries.

The STB would, however, continue to approve mergers and acquisitions under its "public interest" test. Thus, transactions would be subject to dual review, as they are in certain other industries, including transactions in the telecommunications industry subject to Federal Communications Commission ("FCC") review and oil and gas industries subject to Federal Energy Regulatory Commission ("FERC") review. The 2008 House Report on the Act suggests: "[p]assage of the bill would subject railroads to the same kind of concurrent oversight by both a Federal enforcement agency and a regulatory body found in other partially-regulated industries."[33]

The AMC identified only four industries in which regulatory agencies still review proposed transactions under a statutory "public interest" standard, and where the agency can allow transactions to proceed if it concludes "public interest" benefits outweigh likely anticompetitive effects. These industries include (1) certain aspects of electricity and natural gas regulated by FERC, (2) telecommunications/media regulated by the FCC, (3) banking entities regulated by various banking agencies, and (4) railroads regulated by the STB. In the first two industries – electricity and telecommunications – the DOJ has full enforcement authority to investigate and challenge mergers, regardless of the agency's public interest review. In banking, the DOJ provides its analysis to the banking agency, and in practice the DOJ and the banking agencies work closely together. While the banking agency has authority to depart from the DOJ's recommendation, the DOJ can challenge the banking agency's decision in court.[34]

Only in the railroad industry does the regulatory agency have complete discretion to ignore the DOJ. While the STB by statute must give "substantial weight" to the DOJ's views, the STB makes the final decision on whether to allow a merger.[35] Indeed, in 1996, the STB approved the merger of Union Pacific and Southern Pacific, despite the DOJ's objections that the merger was anticompetitive.[36]

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[31] H.R. 233, Sec. 3.

[32] *AMC Report*, *supra* note 10, at 341, 363-66.

[33] H.R. Rep. No. 110-860, at 6 (2008).

[34] *AMC Report*, *supra* note 10, at 341-42, 363-64.

[35] 49 U.S.C. § 11324(d).

The AMC recognized that concurrent merger review by the antitrust agencies and a regulatory agency can impose "significant and duplicative" costs on both the merging parties and the agencies, and can lead to conflicts between the agencies. The AMC suggested that Congress therefore periodically consider whether regulatory agency review under the "public interest" standard is necessary, or whether the antitrust agency's review under the Clayton Act will adequately protect consumers' interests.[37] The Section of Antitrust Law, too, is concerned about the costs of dual enforcement, but recognizing the federal antitrust agencies' expertise in reviewing the competitive effects of mergers and acquisitions, the Section endorses federal antitrust agency review of future railroad mergers and at least removing the STB's exclusive merger review authority.

B. The Filed-Rate Doctrine

The Railroad Antitrust Enforcement Act would specifically abolish the judicially-created "filed-rate" or *Keogh* Doctrine with respect to railroads.[38] Derived from the Supreme Court's 1922 decision in *Keogh v. Chicago & Northwestern Railway*, the doctrine prohibits private plaintiffs from pursuing an antitrust action seeking treble damages where the plaintiff is claiming that a rate submitted to, and approved by, a regulator resulted from an antitrust violation, such as collusion among carriers. The Court reasoned that only the regulatory authority could change the rates, even if those rates were higher than they might be due to a price-fixing conspiracy.[39]

The *Keogh* Doctrine was created at a time when members of regulated industries were required to file their proposed rates with the appropriate regulatory agency.[40] The agency would then review the rates to make sure they were fair and reasonable. In *Keogh*, the Court held that an award of treble damages was not available to a private plaintiff who claimed that rates approved by the regulatory agency violated antitrust principles. While technically neither an exemption nor an immunity, this doctrine effectively protects railroads that file their rates with the STB. Courts have applied the doctrine to preclude antitrust claims where a tariff has been filed with a regulatory agency regardless of whether the agency has actually reviewed and approved the rate.[41] The Supreme Court, in 1986, suggested that a variety of factors "seem[ed] to undermine" the doctrine's continuing validity, but nonetheless concluded it was for Congress to determine whether to abolish it.[42]

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[36] *Union Pac. Corp., et al. Control and Merger Southern Pac. Rail Corp., et al.*, 1 S.T.B. 233 (1996), *aff'd sub nom. Western Coal Traffic League v. Surface Trans. Bd.*, 169 F.3d 775 (D.C. Cir. 1999).

[37] *AMC Report*, *supra* note 10, at 342, 365-66, Recommendation 74. Other organizations studying the interrelationships between regulatory and antitrust review of mergers have also recommended that antitrust agencies have exclusive jurisdiction. *See generally id.* at 365 (discussing recommendations of the International Competition Policy Advisory Committee and the Organization for Economic Cooperation and Development).

[38] H.R. 233, Sec. 2.

[39] 260 U.S. 156, 162-64 (1922).

[40] *AMC Report*, *supra* note 10, at 340.

The AMC concluded that the time has come for Congress to address the issue. It advised: "Congress should evaluate whether the filed-rate doctrine should continue to apply in regulated industries and consider whether to overturn it legislatively where the regulatory agency no longer specifically reviews proposed rates."[43] The Section of Antitrust Law agrees that deregulation within the rail industry, eliminating STB review of most rates, has undermined the *Keogh* Doctrine. The proposed legislation overruling the *Keogh* Doctrine in the railroad industry is therefore consistent with the AMC's recommendation. While the Section believes Congress should consider similar legislation in other industries, the proposed legislation is a step in the right direction, toward curtailing the exemption.

C. Primary Jurisdiction

The Act would also remove any requirement that federal district courts defer to the primary jurisdiction of the STB in any civil antitrust action against a railroad.[44] The doctrine of "primary jurisdiction" is not an immunity. Rather, it addresses the question of whether a court should *suspend* resolution of some questions of fact or law over which the court has jurisdiction, until passed upon by the regulatory authority whose jurisdiction encompasses the activity involved. Such deference may occur when (1) resolution of the case involves complex factual inquiries within the province of the regulatory body's expertise; (2) interpretation of administrative rules is required; or (3) interpretation of the regulatory statute involves a broad policy determination within the special expertise of the regulatory agency.[45] The effect of a court invoking the primary jurisdiction doctrine is referral to the administrative agency and then further court action. While the agency action might be dispositive it will be reviewed by the court applying antitrust standards. Such action is distinct from a court making a finding of express or implied immunity, in which case the agency action would be reviewed on the standards set forth in the regulatory statute, with deference to the agency's fact finding.

The Section of Antitrust Law supports the proposed legislation, which would allow but not require courts to defer to the primary jurisdiction of the STB. District courts currently must defer to the primary jurisdiction of the STB in civil actions against railroads arising under the antitrust laws. The Act would remove this limitation, and would allow successful plaintiffs to recover treble damages in appropriate circumstances.

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[41] *See, e.g., California ex rel. Lockyer v. Dynegy, Inc.*, 375 F.3d 831, 852-53 (9th Cir. 2003); *Utilimax.com, Inc. v. PPL Energy Plus, LLC*, 378 F.3d 303, 306 (3d Cir. 2004).

[42] *Square D Co. v. Niagra Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 423 (1986).

[43] *AMC Report, supra* note 10, at 340-41, 362-63, Recommendation 68.

[44] H.R. 233, Sec. 6.

[45] *See Ricci v. Chicago Mercantile Exch.*, 409 U.S. 289 (1973).

D. Other Exemptions; Other Provisions of the Legislation

The Railroad Antitrust Enforcement Act would remove other exemptions as well. For instance, the Act would allow private parties to sue railroads under the antitrust laws for injunctive relief by amending Section 16 of the Clayton Act, which currently exempts common carriers subject to STB regulation from injunctive relief in private antitrust actions.[46] The Section of Antitrust Law supports this change, and would urge Congress to consider legislation, in addition to this bill, to eliminate the exemption for other common carriers subject to STB regulation.

The bill pending in the Senate would also remove any exemption from FTC jurisdiction, so that the FTC may enforce the Clayton Act and FTC Act against railroads. The House bill is limited to FTC jurisdiction under its "unfair method of competition" authority, so that the agency could not exercise consumer protection authority over railroads.[47]

The Act would also eliminate exemptions from the antitrust laws for leases, trackage rights agreements and ratemaking agreements approved by the STB.[48] The legislation would thereby give authority to the DOJ, FTC and State Attorneys General to enforce the antitrust laws with respect to such transactions notwithstanding any action taken by the STB.

The Section notes that both the Senate and House bills contain provisions to protect conduct that was previously exempted by the STB from antitrust actions. The Senate bill, however, would allow suits after 180 days, if previously exempted conduct or a previously exempted agreement continued after enactment of the legislation. The House bill would make clear that mergers and acquisitions consummated before the bill's enactment remain exempt and firms that engaged in conduct previously exempted by STB approval would have 180 days to discontinue such conduct, and would only be liable thereafter to the extent such conduct were to continue.[49] The House bill would appear to take a more sound approach, to avoid re-opening long-consummated mergers.

The Section also notes that supporters of the Act plead for a more competitive landscape in the railroad industry, claiming that "the absence of competition and apparent allocation of markets have allowed railroads to preserve market share even while eliminating performance

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[46] H.R. 233, Sec. 5.

[47] S. 146, Sec. 5; H.R. 233, Secs. 4, 7.

[48] H.R. 233, Sec. 8. Pursuant to an amendment adopted during the Senate Judiciary Committee's consideration of the bill in 2007, the bill reported by the Senate Judiciary Committee would continue to exempt railroad car pooling arrangements approved by the STB from antitrust scrutiny.

[49] H.R. 233, Sec. 9; S. 146, Sec. 8.

guarantees and dramatically raising prices."[50] They assert that current conditions often hold participants "captive" – i.e., they are forced to rely on a single rail provider for their needs and are unable to protect themselves "through normal business negotiations."[51] The STB has been criticized for allowing railroads to adopt so-called "paper barriers" – when major railroads sell or lease segments of their tracks to short line carriers under contractual terms that indefinitely restrict the ability of the short line to do business with any other major connecting rail carrier – and to refuse to provide their "captive" customers with rates to points where the customer can gain access to a competing railroad. Whether such agreements and pricing practices have legitimate business justifications or will be found to violate the Sherman Act remains to be seen, but they will be subject to scrutiny under the antitrust laws as they would be in any other industry, under the proposed legislation.

Conclusion

The Section of Antitrust Law believes that the changing nature of the rail industry justifies a corresponding change in the way allegedly anticompetitive activity among railroads is addressed. The Section therefore supports Congress's decision to take a closer look at railroad operations in light of the deregulation of the industry.

The Section maintains its longstanding disapproval of statutory exemptions and immunities from antitrust laws and supports the legislature's consideration to reevaluate the *Keogh* Doctrine and the role of antitrust agencies in enforcing healthy competition within the rail industry.

The Section appreciates the opportunity to appear before the Subcommittee to discuss this important issue.

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[50] Testimony of William L. Berg, President & CEO, Dairyland Power Cooperative, before the Senate Judiciary Committee, Subcommittee on Antitrust, Competition Policy and Consumer Rights (Oct. 3, 2007).

[51] Testimony of Ken Vander Schaaf, Director, Supply Chain Mgmt., Alliant Techsystems Ammunition & Energetics Systems, before the Senate Judiciary Committee, Subcommittee on Antitrust, Competition Policy and Consumer Rights (Oct. 3, 2007).

Mr. JOHNSON. Thank you, Mr. Morse.

Mr. Hemmer, would you proceed now?

And by the way, Mr. Morse, that was right within the 5 minutes. I am extremely blown away by that.

Mr. MORSE. We try to be respectful.

Mr. COBLE. Mr. Chairman, would you want to give Mr. Morse 5 more minutes? [Laughter.]

Only kidding.

Mr. JOHNSON. I am afraid not. This subject matter is so riveting that I don't want anyone to get overexcited about it.

But, proceed.

TESTIMONY OF J. MICHAEL HEMMER, VICE CHAIRMAN, POLICY AND ADVOCACY COMMITTEE, ASSOCIATION OF AMERICAN RAILROADS, WASHINGTON, DC

Mr. HEMMER. Mr. Morse set a high standard for performance. I will try to equal it.

Chairman Johnson, Ranking Member Coble, Ranking Member Smith, and Members of the Committee, I am Mike Hemmer, from Union Pacific Railroad. Thank you for the opportunity to comment on H.R. 233 today.

During my testimony today I will review three points and refer you otherwise to the lengthy written testimony that I supplied previously. The first point is, if this bill did nothing more than what Mr. Morse said—that is, to repeal statutory immunities—the railroad industry would not have much trouble with it. My second point, though, is that this bill goes considerably beyond repealing statutory immunities, and I will explain why. And finally, we are concerned about what we believe is the likely retroactive application of those additional changes.

Let me begin, though, if I may, by attempting to dispel a myth. I continue to be astonished at broad statements that the railroad industry is completely exempt from the antitrust laws or broadly exempt and that shippers do not have antitrust remedies. That is a myth.

I am going to hold up a—this is a law firm bill. It is typical of a bill that I receive every month for about a quarter of a million dollars to defend Union Pacific against an antitrust class action—or attempted class action. Cases like this are brought periodically. We win most; we lose some. But we are by no means exempt from the antitrust laws.

As I explained in my written testimony, where the railroads have statutory exemptions today, and some other exemptions, we are prepared to work with you to remove them. This includes allowing dual review of all rail mergers by the Department of Justice and the Surface Transportation Board, so I hope we get that opportunity.

This bill, however, extends beyond simply removing exemptions. And you don't have to take my word for it.

There have been several mentions today of the Antitrust Modernization Commission, which was quite hostile to exemptions, as was the ABA. In annex A of the commission's report, they listed all of the major exemptions from the antitrust laws. I assume you have seen a copy of it—it looks something like this.

I commend it to you. That list did not include the doctrine of primary jurisdiction, which H.R. 233 curtails for railroads only. It did not include the exclusion of FTC jurisdiction over common carriers, which this bill overturns for railroads only. And it certainly didn't mention anything about protecting local communities in STB transactions, which of course, has nothing whatsoever to do with the antitrust laws, but is in this bill.

We believe that H.R. 233 overrides for railroads only fundamental principles of antitrust jurisdiction and of civil procedure, which are embodied in numerous Supreme Court cases. For example, it guides courts that they may not choose to apply the doctrine of primary jurisdiction, which is a fundamental set of principles embodied in numerous Supreme Court cases that instructs courts about how to interact with regulated industries. Frankly, I don't know what a trial judge should do with that guidance.

Moreover, the report accompanying last session's comparable bill virtually instructed antitrust courts that they should disregard antitrust analysis, and instead should override certain Surface Transportation Board decisions. In doing so, they counsel courts not to follow Supreme Court jurisprudence on such issues as unilateral behavior and applied immunity.

To put it simply, this bill does not merely open up the railroads to antitrust—that we have little objection to. It alters substantive law when it comes to railroads, and only to railroads. We think antitrust discrimination against one industry ought to be at least as troubling as antitrust protection of one industry.

So why is this happening in this bill? Last session's Committee report made it quite clear that an objective of the bill was to overturn certain STB decisions that some shipper groups disliked, but that, I must say, were crucial in transforming the railroad industry from the Chrysler Motor Company of its day into a very vibrant and effective industry that meets national needs.

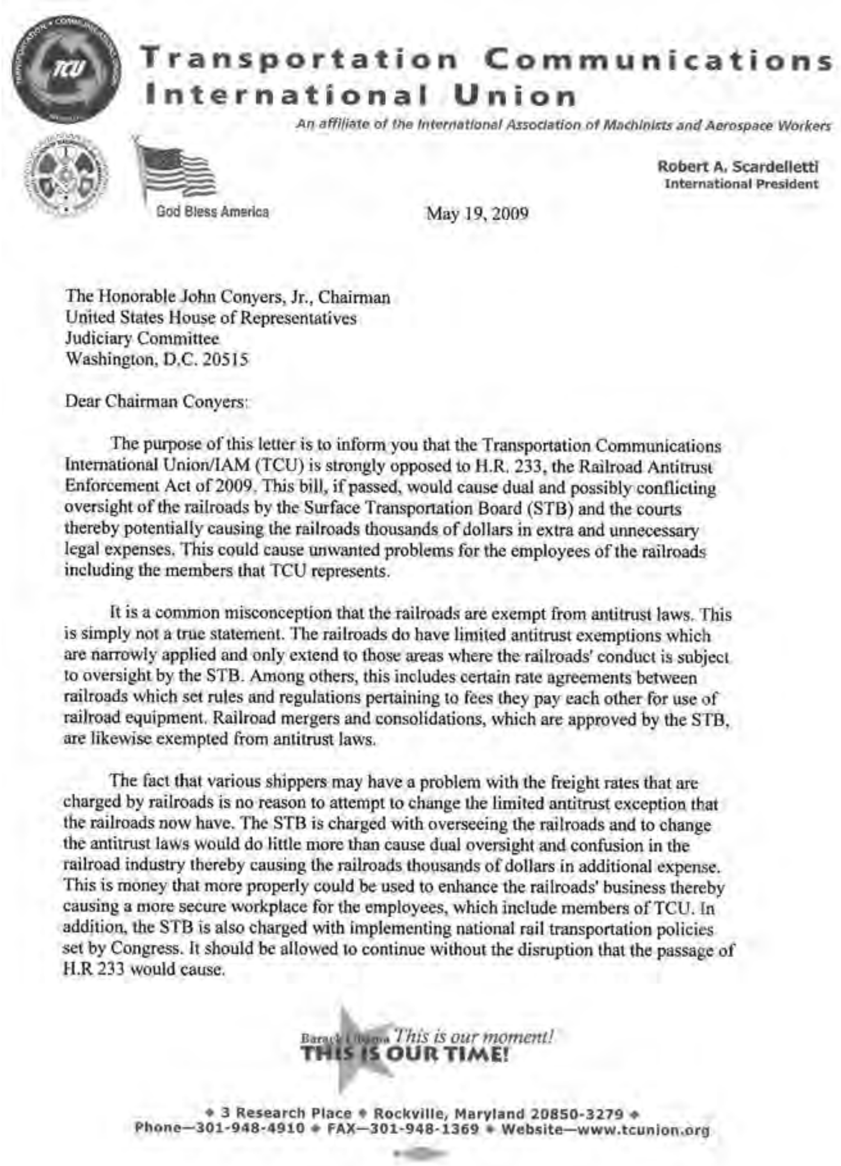
With all due respect, if Congress wishes to change STB regulation, it should do that rather than attempting to use the blunt cudgel of antitrust policy changes to override legislation and create conflicts with regulation—override regulation, I am sorry. We urge, as the Antitrust Modernization Commission urged, that antitrust changes be coordinated with changes, if any, in regulation.

Finally, we also urge you to repair defective section nine, which we believe would allow retroactive application of antitrust law to literally 100 years of STB and ICC decisions, which have conferred express antitrust law immunity. We know you don't intend retroactivity, but as you know, retroactivity is highly unusual. It creates constitutional issues; it may create taking issues. And we believe that you didn't—that that section needs to be repaired.

In closing, I ask that we be allowed to submit for the record three letters from major railroad unions which recognize that this bill could hurt not only shippers and customers and railroads and the national interest, but labor employment——

Mr. JOHNSON. Without objection.

[The information referred to follows:]



Transportation Communications International Union

An affiliate of the International Association of Machinists and Aerospace Workers

God Bless America

Robert A. Scardelletti
International President

May 19, 2009

The Honorable John Conyers, Jr., Chairman
United States House of Representatives
Judiciary Committee
Washington, D.C. 20515

Dear Chairman Conyers:

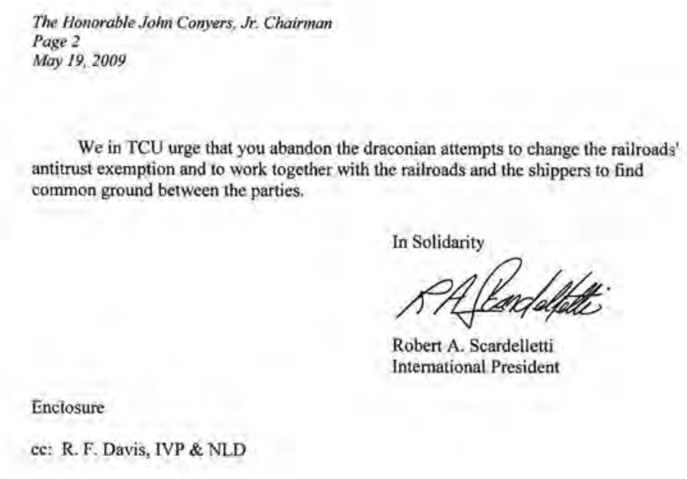
The purpose of this letter is to inform you that the Transportation Communications International Union/IAM (TCU) is strongly opposed to H.R. 233, the Railroad Antitrust Enforcement Act of 2009. This bill, if passed, would cause dual and possibly conflicting oversight of the railroads by the Surface Transportation Board (STB) and the courts thereby potentially causing the railroads thousands of dollars in extra and unnecessary legal expenses. This could cause unwanted problems for the employees of the railroads including the members that TCU represents.

It is a common misconception that the railroads are exempt from antitrust laws. This is simply not a true statement. The railroads do have limited antitrust exemptions which are narrowly applied and only extend to those areas where the railroads' conduct is subject to oversight by the STB. Among others, this includes certain rate agreements between railroads which set rules and regulations pertaining to fees they pay each other for use of railroad equipment. Railroad mergers and consolidations, which are approved by the STB, are likewise exempted from antitrust laws.

The fact that various shippers may have a problem with the freight rates that are charged by railroads is no reason to attempt to change the limited antitrust exception that the railroads now have. The STB is charged with overseeing the railroads and to change the antitrust laws would do little more than cause dual oversight and confusion in the railroad industry thereby causing the railroads thousands of dollars in additional expense. This is money that more properly could be used to enhance the railroads' business thereby causing a more secure workplace for the employees, which include members of TCU. In addition, the STB is also charged with implementing national rail transportation policies set by Congress. It should be allowed to continue without the disruption that the passage of H.R 233 would cause.

Barack Obama *This is our moment!*
THIS IS OUR TIME!

◆ 3 Research Place ◆ Rockville, Maryland 20850-3279 ◆
Phone—301-948-4910 ◆ FAX—301-948-1369 ◆ Website—www.tcunion.org



The Honorable John Conyers, Jr. Chairman
Page 2
May 19, 2009

We in TCU urge that you abandon the draconian attempts to change the railroads' antitrust exemption and to work together with the railroads and the shippers to find common ground between the parties.

In Solidarity

Robert A. Scardelletti
International President

Enclosure

cc: R. F. Davis, IVP & NLD

BROTHERHOOD OF LOCOMOTIVE ENGINEERS AND TRAINMEN

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National President

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March 23, 2009

The Hon. John Conyers, Jr., Chairman
House Judiciary Committee
2426 Rayburn HOB
Washington, DC 20515-2214

The Hon. James L. Oberstar, Chairman
House Transportation and Infrastructure Committee
2365 Rayburn HOB
Washington, DC 20515-2308

Dear Chairman Conyers and Chairman Oberstar:

This letter pertains to the Railroad Antitrust Enforcement Act of 2009 ("the Act"), which has been introduced in the Senate as S. 146 and in the House of Representatives as H.R. 233. The Brotherhood of Locomotive Engineers and Trainmen, a Division of the Teamsters Rail Conference ("BLET"), represents over 56,500 men and women, and is the duly designated and recognized collective bargaining representative for the craft or class of Locomotive Engineer employed on all Class I railroads. BLET also represents operating and other employees on numerous Class II and Class III railroads. As such, the BLET and its members would be significantly and negatively impacted by enactment of the Act. Accordingly, we oppose passage of this legislation, for the reasons stated herein.

For nearly a century and a quarter, disputes between shippers and rail carriers have been subject to the exclusive jurisdiction, originally, of the Interstate Commerce Commission ("ICC") and, for more than a decade, of the Surface Transportation Board ("STB"), who have statutory responsibility for national rail transportation policy as established by the Congress. The railroad industry has played a central role in the development of the nation's economy and transportation under ICC/STB oversight. While carriers, labor and shippers have not been uniformly satisfied with all processes and decisions of ICC/STB, we believe that this oversight has served its public purpose well, as evidenced by the industry's renaissance over the past decade.

As we stated last year in comments in STB Ex Parte No. 677 — the "common carrier obligation" docket — shippers should have prompt and inexpensive access to a process for redress when a carrier abuses its market power. History has shown that STB is the appropriate venue for adjudicating such disputes. For example, on May 19 of last year, the STB announced a decision that it said will require Union Pacific Railroad to grant an estimated $30 million in rate reductions and

A Division of the Rail Conference–International Brotherhood of Teamsters

reparations in a maximum-rate case brought before the Board by Kansas City Power & Light Co. *See* STB Docket No. NOR–42095 (May 16, 2008 Decision).

More recently, the STB found that BNSF Railway had market dominance over the shipment of coal from the Powder River Basin to the Laramie River Station power plant, and awarded the Western Fuels Association and the Basin Electric Power Cooperative rate reductions and reparations that could total $345 million. *See* STB Docket No. NOR–42088 (February 17, 2009 Decision). Given these circumstances, we believe any argument that the STB is asleep at the switch lacks credibility.

As proposed, the Act would essentially vest federal juries with jurisdiction parallel to and contemporaneous with that of STB. This would severely undermine STB oversight, because the Act would provide that "[i]n any civil action against a common carrier railroad … the district court shall not be required to defer to the primary jurisdiction of the Surface Transportation Board." The Act also could lead to forum shopping by shippers. Moreover, the treble damages rule would apply in such cases, which could create havoc for the economic stability of our members and their families.

The nation is in a very fragile state. Our economy is in a shambles, and our dependence upon foreign oil threatens both our national security and the global ecology. Indeed, the gravity of these threats has moved the railroad industry, once again, to the center stage of America's transportation system. Billions of dollars of public funds have been appropriated to improve and expand passenger rail service, and the freight rail industry continues to invest record amounts in infrastructure and capacity improvement, despite the current state of the economy.

The industry is positioned to respond in this manner because of the balanced statutory and regulatory scheme in the transportation industry that has existed for nearly three decades. If passed into law, the Act would severely disturb that balance. A short-term gain for some shippers could result in crippling the industry just as the nation's dependence on railroads becomes critical.

To the extent the Congress believes that the ability of STB to vigorously oversee the railroad industry should be strengthened, we strongly urge you to sit down with the railroads and the shippers and work out the necessary reforms. The BLET supports such a plan of action because it would address legitimate grievances shippers may have without jeopardizing the stability of the industry. Unfortunately, the Act would have the opposite effect. Under these circumstances, we have no option but to oppose passage.

Sincerely,

National President

cc: The Hon. Nancy Pelosi, Speaker of the House
The Hon. Lamar Smith, Ranking Member, House Judiciary Committee
The Hon. John L. Mica, Ranking Member, House Transportation and Infrastructure Committee
The Hon. Henry C. Johnson, Jr., Chairman, House Subcommittee on Courts and Competition Policy
The Hon. Howard Coble, Ranking Member, House Subcommittee on Courts and Competition Policy
The Hon. Corrine Brown, Chairwoman, House Subcommittee on Railroads, Pipelines, and Hazardous Materials
The Hon. Bill Shuster, Ranking Member, House Subcommittee on Railroads, Pipelines, and Hazardous Materials
Matthew K. Rose, Chairman, President and CEO, BNSF Railway
E. Hunter Harrison, President and CEO, Canadian National Railway
Fred Green, President and CEO, Canadian Pacific Railway
Michael J. Ward, Chairman, President and CEO, CSX Transportation
Michael R. Haverty, Chairman and CEO, Kansas City Southern Railway
Charles W. Moorman, Chairman, President and CEO, Norfolk Southern Railway
James R. Young, Chairman, President and CEO, Union Pacific Railroad
BLET Advisory Board
All BLET General Chairmen
All BLET State Legislative Board Chairmen

EWR:tap

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LOCAL 32BJ
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DISTRICT OF LOCAL
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NCFO DISTRICT PRESIDENT

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March 31, 2009

The Hon. John Conyers, Jr., Chairman
House Judiciary Committee
2426 Rayburn HOB
Washington, DC 20515-2214

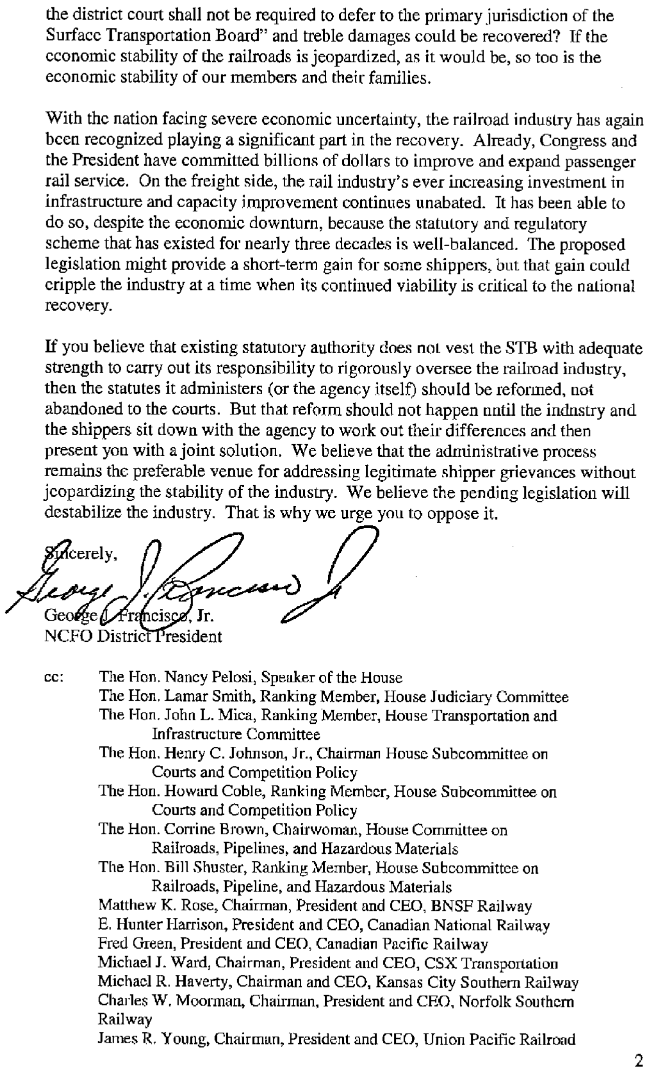
The Hon. James L. Oberstar, Chairman
House Transportation and Infrastructure Committee
2365 Rayburn HOB
Washington, DC 20515-2308

Dear Chairman Conyers and Chairman Oberstar:

I am writing to urge you to oppose legislation to enact the Railroad Antitrust Enforcement Act of 2009 ("the Act"), which has been introduced as S. 146 and H.R. 233. The National Conference of Firemen and Oilers District of Local 32BJ of the Service Employees International Union ("NCFO") represents more than 5,000 of the over 100,000 men and women who belong to Local 32BJ. Our members work as shop laborers, hostlers and stationary engineers in the railroad industry, including on all of the Class I railroads. The passage of this legislation would have a significant adverse effect on NCFO's members.

Disputes between shippers and rail carriers have been subject to the exclusive jurisdiction of the Interstate Commerce Commission ("ICC") and the Surface Transportation Board ("STB") for more than a century. You are well-aware that rail labor has not always been satisfied with the procedures and rulings of the agency, but we recognize that it is Congress that delegated to it the statutory responsibility for implementing national rail transportation policy within Congress's guidelines. Those guidelines have set the stage on which the railroad industry has played a central role in the development of the nation's economy and transportation. In general, ICC/STB has served its public purpose well. Had it not, we would not have experienced the industry's turnaround in recent years.

Two recent examples of the STB's ability to address claims of carrier abuse of market power are the Board's decision to require Union Pacific Railroad to grant an estimated $30 million in rate reductions and reparations in a maximum-rate case brought before the Board by Kansas City Power & Light Co. (STB Docket No. NOR-42095 (May 16, 2008)) and its award of rate reductions and reparations to the Western Fuels Association and the Basic Electric Power Cooperative from BNSF Railway regarding the shipment of coal from the Powder River Basin to the Laramie River Station power plant (STB Docket No. NOR-42088 (February 17, 2009). What the proposed statute would do is move these kinds of disputes into the hands of federal juries. If jurisdiction between the courthouse and the STB became parallel, the agency's oversight ability would be severely hindered. Why would a shipper accept an unfavorable STB ruling when, if the proposed legislation is enacted, "[i]n any civil action against a common carrier railroad ...



the district court shall not be required to defer to the primary jurisdiction of the Surface Transportation Board" and treble damages could be recovered? If the economic stability of the railroads is jeopardized, as it would be, so too is the economic stability of our members and their families.

With the nation facing severe economic uncertainty, the railroad industry has again been recognized playing a significant part in the recovery. Already, Congress and the President have committed billions of dollars to improve and expand passenger rail service. On the freight side, the rail industry's ever increasing investment in infrastructure and capacity improvement continues unabated. It has been able to do so, despite the economic downturn, because the statutory and regulatory scheme that has existed for nearly three decades is well-balanced. The proposed legislation might provide a short-term gain for some shippers, but that gain could cripple the industry at a time when its continued viability is critical to the national recovery.

If you believe that existing statutory authority does not vest the STB with adequate strength to carry out its responsibility to rigorously oversee the railroad industry, then the statutes it administers (or the agency itself) should be reformed, not abandoned to the courts. But that reform should not happen until the industry and the shippers sit down with the agency to work out their differences and then present you with a joint solution. We believe that the administrative process remains the preferable venue for addressing legitimate shipper grievances without jeopardizing the stability of the industry. We believe the pending legislation will destabilize the industry. That is why we urge you to oppose it.

Sincerely,

George J. Francisco, Jr.
NCFO District President

cc: The Hon. Nancy Pelosi, Speaker of the House
The Hon. Lamar Smith, Ranking Member, House Judiciary Committee
The Hon. John L. Mica, Ranking Member, House Transportation and Infrastructure Committee
The Hon. Henry C. Johnson, Jr., Chairman House Subcommittee on Courts and Competition Policy
The Hon. Howard Coble, Ranking Member, House Subcommittee on Courts and Competition Policy
The Hon. Corrine Brown, Chairwoman, House Committee on Railroads, Pipelines, and Hazardous Materials
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Michael J. Ward, Chairman, President and CEO, CSX Transportation
Michael R. Haverty, Chairman and CEO, Kansas City Southern Railway
Charles W. Moorman, Chairman, President and CEO, Norfolk Southern Railway
James R. Young, Chairman, President and CEO, Union Pacific Railroad

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Mr. HEMMER. Thank you, sir. That concludes my remarks, and I would be happy to answer questions.

[The prepared statement of Mr. Hemmer follows:]

PREPARED STATEMENT OF J. MICHAEL HEMMER

HOUSE COMMITTEE ON THE JUDICIARY

SUBCOMMITTEE ON COURTS AND COMPETITION POLICY

HEARING ON H.R. 233

RAILROAD ANTITRUST ENFORCEMENT ACT OF 2009

WRITTEN TESTIMONY OF

ASSOCIATION OF AMERICAN RAILROADS

PRESENTED BY

J. MICHAEL HEMMER

SENIOR VICE PRESIDENT – LAW AND GENERAL COUNSEL

UNION PACIFIC RAILROAD COMPANY

Date of Submission: May 15, 2009
Date of Hearing: May 19, 2009

HOUSE COMMITTEE ON THE JUDICIARY

SUBCOMMITTEE ON COURTS AND COMPETITION POLICY

HEARING ON H.R. 233

RAILROAD ANTITRUST ENFORCEMENT ACT OF 2009

WRITTEN TESTIMONY OF

ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman and Members of the Subcommittee, my name is J. Michael Hemmer. I am the Senior Vice President - Law and General Counsel of Union Pacific Railroad Company. I am pleased to testify today on behalf of the Association of American Railroads and its member freight railroads on H.R. 233, the "Railroad Antitrust Enforcement Act of 2007." The AAR's members account for 75 percent of U.S. freight rail mileage, 92 percent of employees, and 95 percent of revenues.

At the outset, I want to be sure that everyone understands that the rail industry does not object to H.R. 233's stated goal of having the railroads conduct their affairs in accordance with the antitrust laws of the United States. They have done so for decades and continue to do so. The railroads strongly believe that their actions already comport with the antitrust laws in conjunction with applicable regulatory requirements.

The railroads are concerned about some aspects of H.R. 233, because we believe the bill is not simply about removing antitrust exemptions, although most of its supporters probably assume that it is. The aspects of the bill that remove antitrust exemptions are the least troubling provisions.

In many fundamental respects, the bill goes much further. It appears to represent an attempt to overturn long-established regulatory policies that have provided enormous benefits to shippers and American consumers. It even creates new regulatory law on matters unrelated to antitrust. And it consistently treats railroads differently than other regulated industries.

Accordingly, the bill would damage the public interest and severely distort the relationship between regulation and antitrust laws. Moreover, using an antitrust bill to achieve regulatory objectives will produce unintended consequences, and virtually guarantee confusion and disruptive litigation. We will illustrate numerous conflicts between this bill and existing or proposed economic regulation. If the United States Congress wants to address rail transportation policies, it should adopt a unified approach that coordinates economic regulation with antitrust law. They should not be at war.

I. A BRIEF HISTORY OF RAILROAD REGULATION AND ANTITRUST LAW

It is worth recalling that government policies drove railroads to the edge of ruin twice during the Twentieth Century. Early in that century, Congress passed a series of acts that imposed ever tighter regulatory restrictions on railroads in order to reduce shipping rates (prices) and inhibit price competition between U.S. railroads.[1] Investors almost immediately abandoned the railroads, as railroads lost the ability to earn reasonable returns on investments. In fact, a panic over rail securities in 1907 drove the entire economy into a recession.[2]

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[1] E.g., Elkins Act, ch. 708, 32 Stat. 847 (1903); Hepburn Act, ch. 3591, 34 Stat. 584 (1906); Mann-Elkins Act, ch. 309, 36 Stat. 539 (1910).

By the time the United States entered World War I, the railroads had to be nationalized. Nationalization was necessary, not because railroad managements were incompetent to meet the needs of the war, but because the railroads had been unable to invest and were falling apart. Moreover, federal pooling restrictions and antitrust law prohibited coordination to support the war effort. Finally, in 1920, Congress passed the Transportation Act of 1920 to revise regulation and provide the opportunity for the railroads to regain their financial health.

Over subsequent decades, an array of government policies again crippled the railroads. On the one hand, taxpayers subsidized competing forms of transportation—the airlines that took passengers off of private passenger trains and the trucks that took rail cargo onto an Interstate Highway system built with federal funds. On the other hand, the railroads were forced to maintain money-losing services, their rates could not respond to the marketplace, and their attempts to become more efficient were blocked by government action. No one in the railroad industry can forget the Interstate Commerce Commission's ("ICC") refusal to allow a railroad to reduce its rates for grain transportation when it bought larger, more efficient rail cars. Nor will we forget the regulatory nightmare of a rail acquisition proceeding that lasted so long that the intended patient—the weak Rock Island railroad—died on the operating table.

I began my railroad career working as a union employee for the Rock Island, a large midwestern railroad. It went bankrupt largely because of government policies and regulatory delays. Many of my union co-workers lost their jobs. Around that same time, another midwestern carrier and all of the railroads in the Northeast also fell into bankruptcy, throwing tens of thousands of employees out of work. In 1972, the average return on investment of the rail industry was approximately two percent, less than a child's savings account at the time.

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[2] In 1907, the railroads comprised one of America's largest industries and were a major engine of the American economy. Today, all of the Class I railroads combined are smaller than a number of rail customers.

No recession and no financial crisis caused this collapse. Instead, one only needed to look to the government's policies for the explanation.

Today's growing desire to fundamentally increase governmental controls on the railroads, whether in the guise of antitrust legislation or new economic regulation, needs to be considered with 20th Century history as a cautionary tale. To the extent that the objective of any Congressional proposal is to reduce shipping costs for certain rail shippers, whether by regulation or antitrust, public officials should note the following facts:

- Railroads have lost some 20 percent of their revenues in the last three months.
- Congress recently imposed an unfunded government mandate for railroads to install at least $8 billion of Positive Train Control systems.
- The Government is requiring over $2 billion in new environmental controls, with carbon restrictions on the horizon.
- TSA and DOT have imposed hundreds of millions in added costs for secure handling of extremely hazardous chemicals—less than one percent of rail traffic.
- The new administration proposes—and the railroads do not oppose—federal programs to expand passenger train service, mostly on freight railroad tracks that will require additional investment.

The railroads can carry only so many burdens at one time before governmental policy forces them to retrench.

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Freight railroads provide significant public benefits when government's hand is not too heavy. Since the Staggers Rail Act reforms in 1980 adopted national policy that railroads must be allowed to earn their cost of capital, railroads and their investors have delivered a revitalized rail network. We take traffic off of America's highways to reduce congestion and damage to roads. We carry cargo with one-third the carbon emissions of other forms of transportation. We reduce America's dependence on foreign oil by moving a ton of freight 436 miles on one gallon of fuel. We are also cost effective offering the low cost alternative for surface freight transportation. For example, it cost 54% less, in inflation-adjusted terms, to move freight by rail in 2007 than it did in 1981.

And we truly lay golden eggs for America, by doing all of this with private money instead of public funds. We attract private investors to invest billions of dollars in transportation infrastructure that benefits shippers and consumers and displaces taxpayer investment. But all of that private investment will be at risk if the lessons of the past are forgotten.

Much is at stake here. The government cannot force investors to loan money to the railroads. Without that investment, railroads may wither, as they did in the past, and Congress will then be left with the choice of bailing them out with taxpayer funds—or building even more highways. We ask the Subcommittee to be thoughtful about its actions and their potential, unintended consequences. In particular, we ask the Subcommittee to be mindful of the relationship between regulation and antitrust law and to ensure that those regimes work in harmony.

II. RAILROADS ARE ALREADY SUBJECT TO THE ANTITRUST LAWS

Let's return to 1980, when Congress rebalanced regulation with the antitrust laws to save a failing freight industry. Because of the railroad industry's dire straits, Congress removed layers of burdensome regulation when it passed the Staggers Act, under the leadership of the Democratic Representative from West Virginia, Harley O. Staggers. The Act's goals included: "to assist the rail system to remain viable in the private sector" and "to provide a regulatory process that balances the needs of carriers, shippers and the public." Pub. L. 96-488, 94 Stat. 1895, 1897 (1980). Wherever economic regulation was removed, antitrust law took its place. For example, the Act allowed railroads for the first time since the 1800s to enter contracts with shippers outside the purview of the ICC, and in that arena made clear that "[i]f anticompetitive behavior is alleged, under this section, the antitrust laws are the appropriate and only remedy available." Pub. L. 96-448, House Rep. 96-1035, 1980 USCAN 3978, 4003.

The often-asserted claim that railroads are "exempted from antitrust laws in most respects" (S. Rep. 111-9, The Railroad Antitrust Enforcement Act of 2009, p. 2) is a myth. Railroads cannot and do not get together to set prices for competing services. We cannot and do not allocate markets or customers. We cannot and do not engage in the unlawful tying of one product to the purchase of another to harm competition. All of those activities would violate the antitrust laws and would subject us to Department of Justice ("DOJ") action and private treble-damage litigation.

Indeed, at this very moment, certain shippers have brought billions of dollars of antitrust claims against the nation's four largest railroads for allegedly violating the Sherman Act in setting fuel surcharges. In re Rail Freight Fuel Surcharge Antitrust Litigation, D.D.C., MDL No. 1869, Misc. No. 07-489. We believe that those claims are without merit. Union Pacific did not coordinate its fuel surcharge programs with any other railroad, and it alone has employed 57 different fuel-surcharge programs. Nevertheless, the four largest railroads are being forced to spend many millions of dollars per year to defend against these claims. We do not assert in that case that we are exempt from the antitrust laws. Our defense is that we complied with the antitrust laws.

Only in limited areas where the railroads are subject to regulation do antitrust exemptions apply. Vestigial antitrust immunities remain because Congress wanted to retain economic regulation in specific areas in the ICC, renamed the Surface Transportation Board ("STB"). Congress chose to retain economic regulation to protect the public interest, because the agency had a century of experience with railroads and their customers. Congress expressly told that agency to consider a number of policy objectives in discharging its functions. 49 U.S.C. § 10101. Freight railroads are exempt from antitrust laws only where Congress decided that it wanted an agency to pursue those policies in regulating railroads.

Thus, there is no gap—no yawning hole—where railroad actions are exempt from antitrust laws but free of regulatory oversight. Some groups of shippers dislike the way that the ICC and the STB have applied this oversight. (Indeed, we understand that is why some support H.R. 233.) However, whatever may or may not have occurred in the past, the STB is today aggressively protecting shipper interests.[3] If Congress now wants to alter the balance between regulation and antitrust, it should act in a coordinated, not piecemeal manner. This is what Congress has always done to assure that the Nation's transportation policies are harmonized with antitrust laws: "Congress was faced with the duty of harmonizing and reconciling the policy of the antitrust laws as applicable to common carriers with the national transportation policy." S. Rep. 94-499, 1976 USCAN 14, 28. Crossing the boundaries of committee jurisdiction, Congress should coordinate regulation with the antitrust laws. As we will demonstrate, H.R. 233 addresses antitrust exemptions and more without considering interactions with regulation, existing or future. That concerns us, and it should concern all policymakers.

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[3] For example, in a recent decision, the STB reversed a prior decision upholding rail charges and awarded the largest amount of relief in history in favor of a coal shipper and against the railroad. The award cost the railroad some $345 million.

III. ONLY CERTAIN PROVISIONS OF H.R. 233 ACTUALLY REPEAL ANTITRUST EXEMPTIONS

The stated intent of this bill is to repeal antitrust exemptions. In four respects, it does that. First, it would repeal the so-called "Keogh Doctrine." Second, it would repeal provisions of 49 U.S.C. § 10706 that confer antitrust immunity for what were once known as "rate bureaus." Third, it would remove the exemption in 49 U.S.C. § 11321 that prevents DOJ from reviewing proposed railroad acquisitions and mergers. Finally, it would allow private parties, like the Government can today, to seek injunctions. The railroads see no reason to make these changes, some of which discriminate against railroads, but we recognize that they are consistent with the stated purpose of the bill, which is to repeal antitrust exemptions.

A. Eliminate the "Keogh Doctrine" for railroads, but not for utilities. Section 2(a), which would eliminate the Keogh Doctrine (also known as the "filed-rate" doctrine) would have little effect on railroads. Many years ago, the railroads filed their rates—their prices—with the ICC. The ICC reviewed them, opponents routinely filed protests, and the agency often suspended and revised rates. In a case called Keogh, the courts, quite reasonably, ruled that rates supervised by a regulator could not be attacked by shippers seeking damages under the antitrust laws. Keogh v. Chicago & N.W.Ry., 260 U.S. 156, 43 S. Ct. 47 (1922).

While the railroads are still subject to rate regulation, for all practical purposes railroads no longer file their rates with regulators. Accordingly, what the courts would say about railroads and the Keogh Doctrine is far from clear. In any event, I can assure you that no railroad counsel tells a client to act contrary to the provisions of the antitrust laws in reliance on the Keogh Doctrine. Repealing the Keogh Doctrine will have little or no practical effect on railroad actions or shipper remedies.

Ironically, some electrical utilities actively support H.R. 233 even though the primary users of the Keogh Doctrine are electrical utilities. E.g., Utilimax.com, Inc. v. PPL Energy Plus, LLC, 273 F.Supp.2d 573 (E.D. Pa. 2003); aff'd 378 F.3d 303 (3d Cir. 2004). Recent assertions that the electric utility industry is "fully subject to the antitrust laws" are therefore mistaken. Thus, this provision of the bill is one of many that single out railroads for disparate treatment. The Subcommittee could easily modify Section 2(a) of H.R. 233 to level the playing field by repealing the Keogh Doctrine for all industries.

B Repeal antitrust immunity for "rate bureaus". Like repealing the Keogh Doctrine, Section 8(a)'s repeal of rate bureau immunity under 49 U.S.C. § 10706 would have minimal impact on the railroads. The railroads eliminated virtually all of the rate bureaus many decades ago.

As difficult as this may be to believe, railroads for decades were required by law to agree on prices and charge the same price regardless of which route a shipper choose between two points. In that regulatory environment, Congress essentially forced railroads to use rate bureaus to develop rates, and it conferred antitrust immunity on the process. But

Congress changed that policy in the Staggers Act and rebalanced the interface of regulation with antitrust law. The rate bureaus are gone, and railroads must compete on price and service—subject to the antitrust laws. This transition demonstrates that antitrust laws and regulation have long worked in tandem, not at cross-purposes.

For all practical purposes, Section 10706 continues to apply in only one modest respect, which is to establish the complex mechanics for paying rentals for use of rail cars ("car hire") between railroads and by railroads to other car owners. 49 U.S.C. § 10706(a)(d)(C). Railroads do not collectively establish the rental prices they pay each other. They must negotiate those bilaterally. The collective activity merely establishes the processes for payments, collections, adjustments, and the like. This activity is not controversial and is accepted by all stakeholders because it simplifies and therefore reduces transaction costs. It was approved by the STB's predecessor, which prescribed numerous protections, such as recording of all proceedings. The vestigial antitrust immunity for this minor activity facilitates significant efficiencies and should not be eliminated. This collective action might well survive antitrust review as a joint venture, but one of the unintended consequences of this legislation is that this activity may be called into question and the erratic results that emerge from district courts under the antitrust laws would create unnecessary risks and costs.

C. Authorize dual agency review of rail mergers. Section 8 of the bill provides that rail mergers would be reviewed by both the STB and the DOJ. We think dual reviews are unnecessary, and we do not understand what that added review would accomplish other than consuming governmental resources.

Indeed, the Justice Department is likely to impose a narrower competition test on future railroad mergers than would the Surface Transportation Board, which looks to the broader public interest. It is virtually inconceivable that the STB would today approve a major rail merger that the Justice Department, applying its narrower focus only on competition issues, would conclude is anticompetitive.

The STB has strengthened its standards for reviewing rail mergers for competitive effects. In the past, the ICC and the STB consistently ensured that shippers with competing rail service before the merger retained two competitive rail options afterward. The STB required continuation of prior competition through "conditions" on mergers. In 2001, the STB adopted new regulation governing major rail mergers, which would not only protect competition but would improve it. The new regulations elevated the importance of competition to an even higher level, and imposed a new requirement. In most future merger proposals between Class I railroads, the applicants must demonstrate that they have taken steps to enhance competition—to create competition that did not previously exist. 49 C.F.R. § 1180.1. This is a much tougher standard than that established by the antitrust laws, under which the DOJ must persuade a court that the effect of the transaction may be "substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18. The railroads do not understand the benefits of having additional agencies apply narrower antitrust standards to the same transactions with the attendant increase in administrative burdens on such transactions

D. Allow private antitrust injunctions against railroads, but not other carriers. Section 5 of the bill is yet another provision that would treat railroads differently from other regulated carriers. The Clayton Act contains a restriction on private (but not DOJ) injunction actions against common carriers. 15 U.S.C. § 26. Section 5 would treat railroads differently from other common carriers by excluding only railroads from the ban on private injunctions.

That ban was adopted and applied to all common carriers for a sensible reason: it prevents trial courts and juries, which can reach a multiplicity of outcomes, from reaching different and conflicting outcomes than a regulator on matters subject to regulation. See, e.g., Central Transfer Co. v. Terminal R.R. Ass'n, 288 U.S. 469, 475, 53 S. Ct. 444, 446 (1933). Section 5 of the bill, therefore, would create another incompatibility between rail regulation and antitrust. If adopted, it would subject railroads to potentially conflicting obligations, with an agency telling them to behave one way and a jury telling them to pay treble damages for behaving that same way. An antitrust court would be called upon to address a specific set of facts without viewing the broader public-interest implications that a regulatory agency would consider.

IV. SEVERAL OF THE BILL'S PROVISIONS DO NOT REPEAL EXEMPTIONS, ARE DESIGNED TO OVERRIDE REGULATORY DECISIONS, WOULD HARM SHIPPERS, AND CREATE CONFLICTS WITH THE REGULATORY REGIME

Whether intended or not, several provisions of H.R. 233 appear to be designed for the primary purpose of overturning regulatory decisions. This is most obvious with respect to Section 8's directive to the STB to decide certain proceedings in a way that favors the interests of local communities. This provision has nothing to do with antitrust. Similarly, conferring new powers on the Federal Trade Commission ("FTC"), which would apply only to the railroad industry and not to any other type of common carrier, would create a frontal conflict with the STB's "exclusive" jurisdiction over the same subject matter. Finally, and most startlingly, the bill limits as to railroads only the doctrine of primary jurisdiction, which is not an antitrust exemption at all, but a judicially-made and essential accommodation between regulatory regimes and all manner of proceedings in the courts. That provision in particular would have unintended consequences and would, in many contexts, put statutory blindfolds on the courts.

A. Give communities priority rights in some regulatory decisions. Two provisions of H.R. 233 would expressly require the Surface Transportation Board to consider impacts on "affected communities" in making certain regulatory decisions. Section 8(a), 8(b). These provisions are unrelated to the antitrust laws and are instead modifications of regulatory policy.

These provisions are also unnecessary and undesirable. They would adopt "NOT IN MY BACKYARD" as official federal policy for railroad industry transactions. This could block transactions with significant value to shippers and consumers. The rail industry needs to expand over time, and this provision could bar transactions that would be necessary to ensure adequate capacity in the future. Every shipper in America ought to oppose them.

No change in law is warranted. The Surface Transportation Board applies to the National Environmental Policy Act ("NEPA") to consider environmental effects of its decisions, including impacts on communities. The Board's regulations contain extensive rules requiring railroads to file environmental detail in connection with rail transactions. 49 C.F. R. § 1180.6. Far from ignoring those provisions, the Board applies them aggressively. In a recent, small-scale rail consolidation proceeding, for example, the applicants were charged more than $20 million in administrative costs to perform environmental analyses, not including the multi-million-dollar costs of environmental mitigation. Environmental analysis has become the most burdensome aspect of rail consolidation proceedings.

The railroads see no reason to subject the rail industry, or the Surface Transportation Board, to greater environmental review than applies to government action on highway projects, airport expansions, or any other part of the economy. NEPA is an effective law with a fully developed body of interpretations. Accordingly, we respectfully suggest that these provisions to favor local interests have no place in antitrust legislation.

B. Allow the FTC to regulate competition for rail carriers, but not for other carriers, under principles that extend beyond the antitrust statutes. Section 7 of H.R. 233 is yet another example of applying a different legal standard to railroads than Congress applies to other carriers. It also could create a glaring conflict with STB rail regulation.

Section 7 modifies the Federal Trade Commission Act (15 U.S.C. § 45(a)(2)) by excluding rail carriers from a general exclusion that deprives the FTC of jurisdiction over common carriers. Under Section 2(b), the FTC would gain authority over rail carriers under Section 5 of the Federal Trade Commission Act "to the extent such section 5 applies to unfair methods of competition." (See also Section 9(b)). Clearly, railroads would be treated unlike other common carriers, which are not subject to the jurisdiction of the FTC.

The conflict with STB jurisdiction is especially troubling. Indeed, H.R. 233 does not attempt to address an express statutory conflict that it would create with 49 U.S.C. § 10501(b), which grants the STB "exclusive" jurisdiction over rail transportation, rates, classifications, rules (including car service, interchange, and other operating rules), practices, routes, services, and facilities of railroads. Id.

The STB regulates railroad conduct through two primary sources of authority, as well as its general authority. First, the STB has exclusive jurisdiction to determine the scope of a rail carrier's "common-carrier obligation." 49 U.S.C. 11101(a). Indeed, the STB is adjudicating a common-carrier dispute involving Union Pacific today. Union Pacific Railroad Co. -- Petition for Declaratory Order, STB Finance Docket No. 35219. In such matters, the Board's charge is to determine whether a request for transportation is "reasonable" and must be satisfied by the railroad. Granite State Concrete Co. v. STB, 417 F.3d 85, 92 (1st Cir. 2005). As parties in the pending proceeding have argued, this determination involves issues of rail competition. Second, a significant STB role is to determine the reasonableness of railroad "practices," which encompass a wide range of conduct that relates to competition. 49 U.S.C. § 10701.

The clash between FTC jurisdiction over "unfair methods of competition" and STB exclusive jurisdiction over rail common carriage and rail practices is foreseeable and would undermine public policies that matter. The STB is required by law to discharge its exclusive jurisdiction in the public interest and in accordance with the framework of a Rail Transportation Policy that Congress imposed on the agency. 49 U.S.C. § 10101. Its statutory responsibility therefore is to consider an array of public-interest factors. In contrast, the FTC has an entirely separate body of precedent and policy that extends into matters of policy. Although the FTC's focus is on promoting competition, the Supreme Court has made clear that the prohibition in Section 5 of the FTC Act against "unfair methods of competition" encompasses "not only practices that violate the Sherman Act and other antitrust laws, but also practices that the Commission determines are against public policy for other reasons." FTC v. Ind. Fed'n of Dentists, 476 U.S. 447, 454 (1986). The current

Chairman of the FTC has also stated that he regards the FTC as "an agency with authority that extend[s] well beyond the limits of the antitrust laws."[4]

It seems virtually inevitable that the standards applied by these two agencies would diverge, even if both were giving consideration to competitive effects as a principal component of their public interest determination. The nation could be at risk if the STB were to conclude, in the exercise of its wisdom and expertise as regards national transportation policy, that certain conduct furthers the public interest and should be encouraged, whereas an inquiry by the FTC more narrowly focused on its competition-based standards might find that the conduct should be enjoined, thereby thwarting the STB's policy objectives.

This additional, likely conflict underscores the need for coordination between antitrust policy and regulatory policy.

C. Restrict primary jurisdiction for railroads, but no other regulated entities. Section 6 of H.R. 233 restricts the doctrine of "primary jurisdiction," which balances regulation with all other types of law for every regulated industry. Under the primary jurisdiction doctrine, a court will normally defer to an expert agency when the agency has jurisdiction over the subject matter of a legal dispute.

The primary jurisdiction doctrine is not an antitrust exemption at all. As one court explained, the doctrine is properly invoked where there is: "(1) the need to resolve an issue that (2) has been placed by Congress within the jurisdiction of an administrative body having regulatory authority (3) pursuant to a statute that subjects an industry or activity to a comprehensive regulatory scheme that (4) requires expertise or uniformity in administration." United States v. General Dynamics Corp., 828 F.2d 1356, 1362 (9th Cir. Cal. 1987). Discouraging primary jurisdiction would be a major change in jurisprudence that would reach far beyond the antitrust laws. It would leave courts without the benefit of a regulatory agency's expertise when regulation is involved.

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[4] "'Tales from the Crypt' - Episodes '08 and '09: The Return of Section 5 ('Unfair Methods of Competition in Commerce are Hereby Declared Unlawful')," Remarks of Commissioner Leibowitz at FTC Section 5 Workshop (Oct. 17, 2008).

Section 6 would give trial courts the power to disregard agency action, but only with respect to railroads. Accordingly, the many public statements that H.R. 233 is intended to treat railroads like other industries is again not correct. Section 6 would treat railroads uniquely, leaving electrical utilities and other regulated industries with the important doctrine of primary jurisdiction.[5]

Section 6 also proves that H.R. 233 is intended to override regulation, and not merely to remove antitrust exemptions. Exemptions could be removed without touching the primary jurisdiction doctrine. The railroads believe that this overreaching provision is in the bill for the purpose of allowing antitrust attacks to overturn regulatory decisions of the types described below.[6]

1. Allow lawsuits for "bottleneck" rates. Thirty years ago, shippers could dictate railroad routing of each shipment, spreading rail shipments over innumerable routes, increasing costs and preventing railroads from using economies of density. Some shippers took advantage of this power by using railroads as rolling warehouses. They achieved this by requiring railroads to route shipments over the slowest possible routes using the largest possible number of handoffs ("interchanges") between railroads. I recall interchanging transcontinental lumber shipments to the out-of-the-way, 90-mile Oklahoma City, Ada &

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[5] Because of ambiguous drafting, a trial court might be unsure whether to defer to the agency. Section 6 says that the court "shall not be required" to defer, suggesting that courts limit deference. It might or it might not. No one can predict what individual courts will do.

[6] The Committee Report on H.R. 1650 outlined this intent. H.R. Rep. 110-860.

Atoka Railway because shippers wanted to delay the shipments until they could find a buyer somewhere in the South or East.

For the last three decades, federal policy has allowed railroads to act like rational businesses instead. Railroads were given the opportunity to offer faster and more reliable service with fewer handoffs. As a result, railroad productivity has flourished. This productivity saved many billions of dollars, most of which were either passed along to shippers in the form of lower rates and improved utilization of shipper-supplied cars or reinvested in the railroads' physical plant to continue to improve rail service.

However, H.R. 233 would attempt to use the antitrust laws to reverse this successful policy and throw the industry 30 years backward. In the scenario envisioned by the bill, shippers could force railroads to quote rates and reroute rail shipments to any interchange point that the shipper chooses, under threat of treble-damage antitrust lawsuits. This would yield unintended consequences.

The goal, as confirmed by the draft Judiciary Committee Report for last session's bill, is to overturn 1996 STB decisions known as the "Bottleneck Rate" cases.[7] Those decisions, based on longstanding ICC case law, held that, under most circumstances, a railroad that is the only railroad serving a location is not required to compete against itself by delivering shipments to a competing rail carrier over a so-called "bottleneck segment." Instead, the carrier that serves the entire route is allowed to carry the shipment all the way from origin to a destination on its own route.[8] Some shippers believe that this decision deprived them of competition between two carriers over portions of rail routes where there is more than one available rail line.

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[7] E.g., Central Power & Light Co. v. Southern Pacific Transportation Co., 1 S.T.B. 1059 (1996), aff'd sub nom. MidAmerican Energy Co. v. STB, 169 F.3d 1099 (8th Cir. 1999)

[8] The originating carrier must, of course, interchange a shipment to another carrier if the originating carrier cannot serve the destination.

Years of debate about the "Bottleneck Rate" cases have yielded an abstract, dry discussion about regulatory theory. This debate has lost sight of a critically important, real-world fact. If H.R. 233 were passed in its current form, and if railroads were required by antitrust courts to provide service on any "bottleneck" segment a shipper selects,[9] the physical operations of the nation's rail network would be severely disrupted, returning the industry to the lower productivity of the pre-Staggers Act era.

Requiring "bottleneck" service on demand would change the physical routing of rail cars. It would undermine railroad productivity built under three decades of public policy. It would increase railroad costs. It would impair service quality and reduce asset utilization. It would strand railroad assets in which railroads invested billions of private capital in recent years. It would require new investments to support new routings (assuming railroads could raise money from investors), yet shippers could change their minds about those routes on a whim. It would create new impacts on local communities and negative environmental impacts by forcing traffic through little-used connection points and over little-used rail lines throughout the nation.

What is important to recognize, which H.R. 233 does not, is that any evaluation of "bottleneck" practices needs to address two fundamental concerns, i.e., the impact on rail network operations and the appropriate level of compensation for the "bottleneck" carrier. These issues are properly within the purview of regulatory, not antitrust, policy. Also often forgotten when "bottleneck" issues are discussed is that the STB retained and still has the power to regulate the originating carrier's rate to ensure that it is "reasonable," thereby protecting the shipper, and the STB is very active today.[10]

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[9] The railroads do not concede that an antitrust court would find a refusal to quote a bottleneck rate unlawful. Recent Supreme Court decisions reject an antitrust duty of one firm to aid a competitor under most circumstances. See Trinko, Linkline, cited below.

No one has studied, or could comprehensively study, the full operational or environmental effects of a "bottleneck rate" requirement on the national rail system, and the Subcommittee has no way of knowing how disruptive and damaging it would ultimately be. Evaluating the public interest in a network industry is inevitably a regulatory function. By turning the question over to individual courts, none of which would take into account the total rail network concerns, H.R. 233—if attacks on regulatory policy succeed—would produce inconsistent and disruptive decisions by the courts. As a reminder, the railroads would strongly contest any attempt to use the antitrust laws in this way.

Note also that the objective of the proponents of these lawsuits – lower rates – could not be achieved through resort to the antitrust courts alone. Even if such courts did order a railroad to provide service and quote a rate, they would not have a basis for establishing a rate at any particular level. Courts are not equipped to engage in ratemaking, and the Supreme Court has instructed that they not engage in this activity in antitrust cases. As the Supreme Court reiterated only a few months ago, "Courts are ill suited 'to act as central planners, identifying the proper price, quantity, and other terms of dealing.'" Pacific Bell Telephone Co. v. Linkline Communications, Inc., ___ U.S. ____, 129 S. Ct. 1109, 1121 (2009) (quoting Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 408, 124 S. Ct. 872, (2004).). The Court endorsed the view that antitrust courts should not get involved "when compulsory access requires the court to assume the day-today controls characteristic of a regulatory agency." Id. at 415. Yet Section 6 ironically cautions them against deferring to any agency for assistance.

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[10] In addition to handing down the biggest rate award in its history, the STB recently mediated a "small shipper" case to a satisfactory settlement. Another shipper filed another such case this month against Union Pacific.

2. Allow attacks on "paper barriers." Similarly, another principal objective of H.R. 233's restriction on primary jurisdiction, as shown by last session's Committee report, is to overturn so-called "paper barriers." What is a "paper barrier"? It is a provision of a sale or lease from a larger railroad to a smaller rail purchaser or a lessee of a rail line that was previously operated by the larger railroad, but which both parties agree can be operated more efficiently by the smaller railroad. The "paper barrier," in one way or another, provides that the majority of the rail traffic that originates or terminates on the segment operated by the smaller railroad would continue to flow over the larger railroad's network, as it did before the transaction.

Why do large railroads and smaller railroads enter into contracts with "paper barriers"? They do so because the smaller railroad could not otherwise afford to acquire or lease the rail line at all, and because the traffic handled by the smaller railroad continues to be important to supporting the larger railroad's network. Most of these short rail lines are barely economical to operate, even with their lower cost structures afforded by these transactions. Therefore, a "paper barrier" is simply a very efficient financing mechanism, allowing both the smaller and larger railroad to share in the benefits of the transaction by sharing traffic, rather than requiring the smaller railroad to pay the large railroad money up-front or make annual rental payments. To illustrate the point, no lessee of a Union Pacific rail line has within memory—if ever—paid any rent for the use of Union Pacific's properties. They pay "rent" by routing traffic over Union Pacific.

"Paper barriers" have been a huge success for the nation's shippers and consumers. They spawned an entire industry of hundreds of short-line railroads, which have a reputation for providing high quality, customer-oriented service. These transactions also have avoided the unpleasant alternative: in many instances, the larger railroad would otherwise have abandoned service on the rail line, eliminating rail service altogether and also eliminating the opportunity for new shippers to locate on that rail line. In addition, some of the transactions create new competitive opportunities that did not previously exist. Some transactions allow a portion of the shipments to be routed via a competing carrier—new competition that might not have existed without the transaction. Finally, the railroad industry has developed a process to allow service over a competing rail carrier for new shippers who locate on a short line under most conditions where the shippers' traffic would otherwise be lost to rail transportation if the "paper barrier" was not waived.[11]

For decades, the ICC and the STB strongly supported these spin-offs, including their financing arrangements. Proponents of H.R. 233 hope to overturn "paper barriers" using the same mechanism that would be applied to overturn the Bottleneck Rate cases. Under Section 6, the courts would be guided not to defer under primary jurisdiction to the regulatory agency that approved the transactions and instead to allow attacks on regulatory decisions. The railroads do not believe that antitrust attacks would succeed, but they would have undesirable effects if they did. (The railroads also believe that any successful attacks would raise Constitutional issues.)

Meanwhile, this has become a solution looking for a problem. The STB has already revised its policies to effectively discourage future transactions that use "paper barriers," and it has opened up the opportunity to challenge existing transactions. STB Ex Parte No. 575, Review of Rail Access and Competition Issues – Renewed Petition of the Western Coal Traffic League (Decision served Oct. 30, 2007). That STB decision has already had the unfortunate result of ending the creation of new short lines by my railroad. If a purchaser cannot pay rent on our assists, we have no motivation to make the assets available for free. If H.R. 233 passes, an unintended consequence will be that the "short line movement," as it is called, will end. No railroad would risk an antitrust case when it can retain its lightly-used rail lines—or abandon them—and avoid the risk.

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[11] Rail Industry Agreement between the larger railroads and the American Short Line and Regional Railroad Association.

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The railroads are not aware of any effort to reconcile proposed changes in the application of antitrust law to railroads with either existing railroad regulation or with proposed changes to regulation that both Houses of Congress are considering. Indeed, some advocacy groups are explicitly supporting this legislation, while simultaneously pursuing separate legislation that would address the same topics by regulation.

We are not aware of any study of the effects of the inevitable interactions between these regimes on the railroads, on shippers, or on consumer welfare. Many assume, automatically, that more antitrust exposure automatically advances the public interest, but, hundreds of times in the past, Congress has reached the opposite conclusion. It has expanded economic regulation and created immunities to allow regulation to function. No one can be certain what effects a new mix might have if it comes to pass, but they would surely be inefficient, uncoordinated, and likely contrary to the Nation's vital transportation needs.

Finally, in many ways, if antitrust law remains as it is today, this legislation does not even solve its proponents concerns. But the bill's unintended consequences for rail investment, because of the uncertainty it creates and the potential for conflicting court decisions, and the impacts to rail efficiency are large.

IV. H.R. 233 RAISES SIGNIFICANT CONCERNS ABOUT RETROACTIVE APPLICATION

Jurisprudence dating back over 200 years establishes that laws normally apply only prospectively. As the Supreme Court explained in its most recent decision on the subject:

> "Elementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly; settled expectations should not be lightly disrupted. For that reason, the 'principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal appeal.'"

Landgraf v. USI Film Products, 511 U.S. 244, 265 (1994) (citations omitted). We assume that the Subcommittee intends H.R. 233 to apply only prospectively. The language of Section 9, however, leaves ample room for an antitrust agency or plaintiff to bring a case attacking past conduct—conduct that has been expressly immunized from the antitrust laws.

Section 9(b) prohibits antitrust actions based on behavior that: (1) occurs after the 180th day after enactment of H.R. 233; and (2) was previously immunized from the antitrust laws. This leaves open the possibility that transactions previously approved as in the public interest, immunized from the antitrust laws, and fully implemented may be challenged as unlawful, if the conduct that is the essence of the approved transaction continues on the 181st day. This, in turn, could lead to antitrust attacks on the continuing operation of every ICC-approved or STB-approved transaction in railroad history.

To take an example involving my company, Union Pacific received ICC authorization in 1982 to acquire the Missouri Pacific Railroad Company and Western Pacific Railroad Company, two other western railroads. Pursuant to the governing statute, the ICC's approval order gave UP full and unrestricted authority to take all steps necessary to implement that merger, including combining the three companies and unifying their operations. Union Pacific—Control—Missouri Pacific, Western Pacific, 366 I.C.C. 462 (1982). All of that happened, and the three former railroads are no longer distinguishable. Nevertheless, under Section 9, an antitrust plaintiff could argue that the ongoing conduct made possible by the acquisition, although lawful in every respect at the time and implemented with antitrust immunity, violates antitrust standards on the 181st day after enactment.

This problem, of course, is not limited to the Union Pacific-Missouri Pacific-Western Pacific transaction. It applies with equal force to hundreds of rail mergers and line sales from the past. Logically, the same claim could be raised against other rail mergers and line sales approved 20, 40, or even 60 years ago, involving railroads we hardly remember today, as well as many other approved transactions.

In the event such antitrust actions proceeded, and succeeded, the railroads would probably raise due process claims under the United States Constitution, given the regulatory framework that exempted these transactions from antitrust scrutiny when the parties elected to consummate them. Railroads also could assert massive "takings" claims under the Tucker Act, which could end up costing taxpayers billions of dollars. This is just another unintended consequence of the legislation of which policy makers should be aware.

We respectfully suggest that the Subcommittee take a very close look at the language of Section 9 and eliminate this potential retroactive application.

V. THE BILL AND ANY COMMITTEE REPORT SHOULD NOT PREJUDGE ANTITRUST CASES OR ATTEMPT TO ALTER ANTITRUST JURISPRUDENCE

The railroads understood that H.R. 233's purpose is to remove exemptions and open the courts for antitrust complaints. As we have already noted, the bill does much more than that.

Neither the language of the bill nor any accompanying report should prejudge how a court should decide a case. The railroads are concerned, because the Report for last Congress's H.R. 1650 strongly suggested that the railroads had already been put on trial and lost.

Regarding "bottleneck rates," long-established Supreme Court precedent, cited earlier, holds that firms must aid, or provide their assets to, competitors under only rare and unusual circumstances. In general, firms, including firms with monopolies, are free under American law to decide with whom they will do business. See Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 408 (2004) ("as a general matter, the Sherman Act 'does not restrict the long recognized right of [a] trader or manufacturer engaged in an entirely private business, freely to exercise [its] own independent discretion as to parties with whom [it] will deal'") (quoting United States v. Colgate & Co., 250 U.S. 300, 307 (1919)). That right is not entirely unqualified, but the Supreme Court has instructed extreme caution in basing antitrust liability on a "refusal to cooperate with rivals." Id., 540 U.S. at 408-10 (noting, for example, that the Aspen Skiing case, Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985), which found liability on facts where an alleged monopolist discontinued a prior course of cooperation, is "at or near the outer boundary of §2 liability"). An antitrust court would be even less likely to rule for a plaintiff in an industry structure where a regulatory agency offers a remedy for unreasonable prices and also has the authority to grant the kind of competitive access that seekers of bottleneck rates desire. See id., 540 U.S. at 411-12 (noting that regulatory structure that enabled a regulator to grant access counseled strongly against applying the antitrust laws).

Regarding "paper barriers," sales and leases to shortline railroads do not reduce competition in any way. The transactions preserve service on a rail line that might otherwise be abandoned and preserve the competitive situation that existed before the transaction. Contractual provisions that are a central part of the consideration for such transactions, and which address the basic terms of the ongoing traffic-interchange relationship between the large railroad and the smaller railroad it created, should not be found unreasonably anticompetitive by antitrust courts.

We have been told that the objective of H.R. 233 is simply to open antitrust courts to shippers by removing exemptions. However, the report that accompanied last session's H.R. 1650 went further, strongly suggesting that the drafters had already tried and convicted the railroads. We respectfully ask that the report remain neutral regarding how antitrust courts should decide any new case.

It would come as a major surprise if H.R. 233 were intended to revise decades of antitrust jurisprudence or to make substantive changes in those laws. Similarly, it would be quite surprising if this bill, directed at one industry, were to be viewed as overturning Supreme Court decisions. Accordingly, we respectfully suggest that the bill should include a "savings provision" stating that the bill has no such intent. The bill should not create any presumption or inference that any conduct or activity is in violation of the antitrust laws.

VI. CHANGES IN ANTITRUST LAW AND RAIL REGULATION MUST BE COORDINATED

Congress should address the interaction of antitrust laws with the regulatory regime it has already established or that it may establish in the future. Because parts of H.R. 233 are designed to override regulatory decisions, they would inevitably create conflicts and uncertainty for railroads, railroad customers, and courts. That same uncertainty may cause investors to be cautious about the railroad industry, increasing borrowing costs and reducing the railroad industry's ability to draw capital from the private sector. The railroad industry urges this Subcommittee not to act in isolation, but to work with colleagues in other committees of jurisdiction to craft a coherent, national rail policy that integrates regulation with antitrust jurisprudence.

Conflicts with regulatory regimes become especially evident if one contrasts H.R. 233 with H.R. 2125, introduced during the last Congress. H.R. 233 is designed to allow shippers to challenge so-called "paper barriers" in antitrust courts. Section 103 of H.R. 2125 addressed the same matter, granting the STB the authority to review future "paper barriers" under specific standards and to make policy decisions about whether terminating the "paper barrier" would "materially impair the ability of an affected rail carrier to provide service to the public or would otherwise be inconsistent with the public interest." Antitrust courts are not equipped to apply those specific standards or to make the policy decisions that H.R. 2125 would have imposed.

Similarly, H.R. 233 is designed to allow shippers to bring antitrust claims to force railroads to provide “bottleneck” service on demand. Section 102 of H.R. 2125, however, gave that power explicitly to the Surface Transportation Board, eliminating any role for antitrust courts. H.R. 233 creates yet another direct conflict with existing and future regulatory policy by authorizing the FTC to regulate practices that the STB also regulates, creating conflicting results.

As noted earlier, Section 6 of H.R. 233 would confuse matters still further by directing that courts "shall not be required to defer to the jurisdiction of the Surface Transportation Board." Section 6. Thus, while district courts are discouraged from deferring, they may defer. As a result, different courts and the regulatory agency could well reach opposite conclusions about the same type of dispute or even the very same actions. For example, a district court might conclude that a particular railroad practice is unreasonable under the antitrust laws, but the Surface Transportation Board might decide that the practice is in the public interest. Congress should not allow such conflicts to arise, much less induce them.

In both Houses of Congress, we believe legislation is likely to be introduced that would propose to alter regulation of our rail industry. Antitrust laws should be carefully and thoughtfully integrated with existing regulation or whatever legislation is proposed from the commerce committees. Pushing forward with laws that address the same subject matter can only produce confusion for all stakeholders in rail transportation, and involve the courts and agencies in years of litigation to unwind the confusion. Throughout that uncertainty, investors would be reluctant to invest their dollars in an industry with an uncertain future. We urge this Subcommittee to pursue rational coordination, not a flawed partial solution that may be undermined by future legislation.

Mr. JOHNSON. Thank you sir.

Next we will hear from Mr. Terry Huval.

TESTIMONY OF TERRY HUVAL, DIRECTOR, LAFAYETTE UTILITIES SYSTEM, LAFAYETTE, LA

Mr. HUVAL. Thank you very much, Mr. Chairman. My name is Terry Huval, from Lafayette, Louisiana. I would like to thank the Members of the Subcommittee for allowing me to testify before you today.

I am appearing on behalf of my community, Lafayette, Louisiana. I am at America Public Power Association, which represents 2,000 publicly-owned utility systems in the country, and the Consumers United for Rail Equity.

What we are asking is to seek removal of any antitrust law exemptions applicable to railroads, which we believe—and we will be able to show you in a couple of minutes—affects the marketplace and creates significant—of harm to our customers and the customers of many other entities. House Resolution 233, the Railroad Antitrust Enforcement Act of 2009, we think is a necessary step.

We congratulate, of course, the Judiciary Committee of last year for having voted for similar legislation, and believe that taking this to the final conclusion would be in the best interest of the public.

I want to tell you a little story about Lafayette, Louisiana. We serve 125,000 people. Those are residents of our population. We have 60,000 customers, as a whole. We own 523 megawatts—50 percent of our 523-megawatt Rotomaker Power Plant in Boyce, Louisiana.

We are the 50 percent owner of that 523-megawatt unit; been an owner of that unit since 1982. And that particular unit provides almost two-thirds of our electricity, so whatever cost impacts affect that plant have an impact on two-thirds of the energy costs that we provide to our customers.

If you look at the screen, I will refer you to the trek that our coal must take from the Powder River Basin in Wyoming all the way down to Louisiana. You will notice that we have one rail provider that is in red and an alternative rail provider that is in green and blue.

The whole trek to our plant is 1,500 miles; 1,480 miles of that trek has a competitive option. In other words, we could either choose, in a purely competitive environment, to buy rail transportation from the company in red or we could purchase from the company in green or blue. The only part that is subject to monopoly control, where there is only one provider, is the last 20 miles to our plant.

But as the Surface Transportation Board addresses an issue like this, they will not force or put the railroad companies in any position where they have to give us a price either for the last 20 miles, so therefore we could get a competitive option for the 1,480 miles coming is, or for us to be able to get a price from the competitive provider so we could make a decision on how we would deal with the last 20 miles. And that is tied down to the Surface Transportation Board's 1996 bottleneck decision, which allows this practice to take place where we are forced to have to take rail service on from one provider.

So, bring it to some simple conclusions, and that description nets us 1 percent of our rail—the rail I take to get the service—that 1 percent monopoly transforms itself to monopoly over the entire train route. What does that do to our customers? Since 1999 we estimated that our customers have paid over $65 million more in energy costs because of those additional costs for rail transportation. Those costs are passed directly to our customers.

As an example, 10 percent of our total electrical service in Lafayette, Louisiana is provided to educational institutions, public and private. That means that that $65 million translates to $6.5 million that those public and private educational institutions have had to pay over the last 10 years. The remainder of the $65 million, of course, goes to everybody else—all of the businesses, all of the residences in our community.

In addition to costs, we have had service quality level interruptions, where because of derailment, because of lack of proper maintenance of the tracks, that we have had to purchase coal from Venezuela and have that shipped to our plant. We have had to use late night, which created some operational problems with our plant. We have had to move forward with prematurely retiring steel coal cars in exchange for aluminum coal cars at a price of about $16 million, the purpose of that being, of course, to be able to get all of our coal in the event of a disruption.

And so I ask this Committee to strongly consider and to vote into this—this bill to move forward. We believe it is what is necessary to negate the anticompetitive behavior that we have experienced, and until the Surface Transportation Board's bottleneck decision is rescinded, this problem will persist.

So I encourage your passage of H.R. 233 and thank you for your attention, and I look forward to answering any questions that you may have later on.

[The prepared statement of Mr. Huval follows:]

PREPARED STATEMENT OF TERRY HUVAL

Testimony of Terry Huval
Director, Lafayette Utilities System
Lafayette, Louisiana

Before the
Subcommittee on Courts and Competition of the House Judiciary Committee

Hearing on H.R. 233,
the "Railroad Antitrust Enforcement Act of 2009"

Mr. Chairman and Members of the Subcommittee, my name is Terry Huval, and I serve as the Director of the Lafayette Utilities System ("LUS") in Lafayette, Louisiana. I am appearing here today on behalf of LUS and the American Public Power Association (APPA). Thank you for the invitation to participate in this hearing on H.R. 233, the Railroad Antitrust Enforcement Act of 2009.

LUS greatly appreciates the opportunity to appear today before the Subcommittee to discuss a matter of considerable importance to consumer protection and the public interest. We seek the removal of antitrust law immunities and outdated policies that have contributed to the current competitive problems confronting rail customers, including LUS, and that are producing significant marketplace harm. LUS and numerous other consumers across Louisiana and this Nation believe that H.R. 233 offers an important step in helping to address some of the competitive problems facing railroad customers today.

We are pleased that the House Judiciary Committee favorably reported identical legislation last year and that, earlier this year, the Senate

Judiciary Committee favorably reported companion legislation, S. 146, by a bipartisan recorded vote of 14-0. We respectfully urge this Subcommittee and the full House Judiciary Committee to report H.R. 233 favorably to the full House. We also respectfully urge Congress to pass this legislation this year. It is long past time for the railroad industry to be subject to all of the Nation's antitrust laws.

I. LUS AND ITS RELIANCE ON THE RAILROADS

LUS is publicly owned and operated, and is a part of the City of Lafayette, Louisiana, a community of 120,000 located approximately 135 miles west of New Orleans. LUS exists to serve the electric power and other utility service needs of its citizens and business owners in Lafayette. As a community-owned utility, LUS is committed to providing electricity to our customers at the lowest possible cost with the highest reliability of service.

While LUS owns a mix of coal-fired and gas-fired electric generation on which it relies to meet customer demand, the majority of its electrical energy is derived from the 523 Megawatt coal-fired Rodemacher Power Station Unit No. 2 located in Boyce, Louisiana. LUS is a 50 percent owner of the Rodemacher plant. The remainder of the facility is owned by an investor-owned utility in Louisiana and several other municipalities in Louisiana through their membership in a joint action agency. This Rodemacher coal unit has been in operation since 1982 and is an essential component of our generation portfolio, as it provides over 65 percent of the electric energy used in the City of Lafayette.

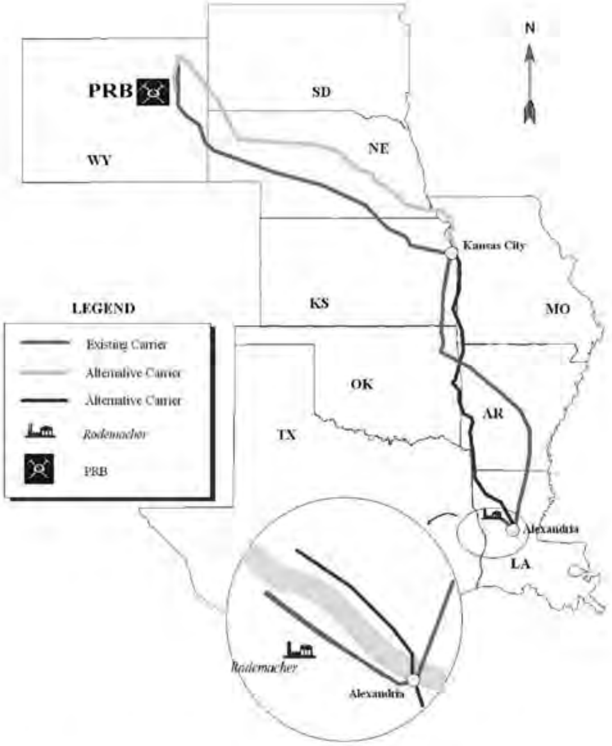
The Rodemacher plant's co-owners obtain the coal used at Rodemacher from mines in the Wyoming Powder River Basin (PRB) and collectively purchase approximately two (2) million tons of coal annually for use at Rodemacher. The only practical way to transport this coal from Wyoming to Rodemacher (a distance of over 1,500 miles) is by rail. To facilitate its rail deliveries, the Rodemacher co-owners have obtained and maintain, at the total expense of the co-owners, four (4) train sets of coal cars. Two (2) of those train sets are new aluminum car train sets (a total of 246 new railcars) that were very recently purchased by LUS for its service at considerable cost (approximately $16 million) in order to facilitate improved Rodemacher rail service and mitigate railroad service lapses, which I will describe later in this testimony.

II. LUS' RAIL COMPETITION PROBLEM

LUS is a classic captive rail customer. The Rodemacher station is served by only one railroad, the Union Pacific Railroad Company (UP). Theoretically, LUS has competition for much of its Rodemacher rail service. Two railroads originate coal in the PRB, the UP and the BNSF Railway Company (BNSF). BNSF and Kansas City Southern Railway Company (KCS) have connecting rail lines in place covering approximately 99 percent of the 1,500 miles between the PRB coal mine origins and Rodemacher. However, Rodemacher is captive to UP at destination because only the UP serves the last 20 miles into the Rodemacher plant in Boyce.

The existing and possible alternative service routes to Rodemacher are set forth in the schematic below, which is also reproduced in the Attachment to this Testimony:

Selected Routes For PRB Coal Moving to Rodemacher



A review of this schematic would suggest that in a partially deregulated rail system where effective competition is intended to take the place of government regulation, the Rodemacher plant would have two options: (1) a single rate on the UP from the PRB coal fields to the plant or (2) a competitive rate from either UP or BNSF/KCS to the junction point in Alexandria, then a rate from UP only from the junction to the plant. The second option would allow LUS to have railroad competition for all but the last 20 miles of our haul from the PRB to the Rodemacher plant.

Unfortunately, under the Surface Transportation Board's (STB's) ruling in 1996 in the so-called "Bottleneck Decision," the UP is not required today to provide a rate from the junction in Alexandria to the plant. Rather, the UP may only provide Rodemacher one rate from the PRB to the plant, making us captive – and paying high captive rail rates – from the PRB to our plant. Were we able to obtain a rate from the junction in Alexandria to our plant, then we would have a relatively short route where we have only one option and 1,480 miles, out of the total 1,500 mile haul, where we would have the chance of competition between the UP and the BNSF/KCS.

As discussed below, we believe our total rail bill should be substantially lower if we were able to obtain a rate from the UP that allowed us to access rail competition for 99% of the route to the Rodemacher plant and, as a result, the involved carriers effectively competed for this business.

LUS supports a strong national coal delivery network by rail, but it is in the Nation's interest to have a sound railroad system built on reasonable, not predatory, pricing and service. Under the STB's interpretation of the law, UP may use its monopoly "bottleneck" control over rail line facilities at the plant destination to extend its 20 miles of monopoly power to the entire 1,500 miles of the route from the PRB to Rodemacher. In other words, UP's exclusive control of only 1 percent of the involved essential rail line to the Rodemacher plant enables UP to control 100 percent of the Rodemacher movement. This renders Rodemacher captive to UP for the entire origin-to-destination trip.

A. The Cost of Captivity

The cost of coal transportation is one of the single largest LUS electric generation expenses. Unfortunately, LUS pays substantially higher coal transportation prices than it would if we had access to effective origin-to-destination rail competition. For Lafayette, Louisiana, we believe this lack of railroad competition has translated into over $65 million in "captivity payments" during the last ten years – the difference between what LUS has paid its existing rail carrier between 1999 and 2008 compared to what LUS estimates it would have paid if it had access to effective railroad competition. These higher payments are included in LUS customers' monthly electric bills and cause higher utility bills for all individuals and businesses in Lafayette.

To add insult to injury, our rail service has been inconsistent over the years, as UP has suffered well-documented PRB coal delivery problems, most recently in 2005-2006. In response to the 2005-2006 UP delivery failures, LUS undertook extraordinary measures to ensure an adequate coal supply. More specifically, LUS had to buy barge-delivered coal from Venezuela and truck lignite from Northwest Louisiana to help shore-up fuel inventory. In addition, LUS decided to replace prematurely (before the end of their useful life) its steel railcars with new aluminum railcars, which can carry more coal per train run, in an effort to help ensure that LUS is in the best position possible to meet the Rodemacher plant's annual coal requirements, even with UP service failures.

This railcar replacement initiative was designed to assist UP to deliver more coal to Rodemacher in a timely manner and meet Rodemacher's annual coal volume requirements. But there are no guarantees and we are receiving little in return from UP for making these very expensive investments that produce considerable operating expense savings for UP. While our service has improved since 2005-2006, these are significant costs for a small utility that LUS would not need to incur if it was otherwise receiving reliable service on a consistent basis and/or was able to obtain reasonable guaranteed service standards from UP.

1. Consumer Impacts

Very frankly, LUS customers must ultimately pay, in the form of higher electric rates, the $65 million in extra captivity payments LUS has been required to pay. These overpayments are of critical importance to the City of Lafayette and its citizenry and businesses. Our customers care deeply about the cost of their electricity, and share LUS' concern about the need to ensure that our electric generation costs are kept as reasonable as possible.

For example, each year Lafayette educational institutions (e.g., the university, community colleges, trade schools, and all public and private schools) served by LUS consume approximately 10 percent of the total energy produced and purchased by LUS. Based on the aforementioned $65 million in captivity payments to LUS' rail provider, these schools are in turn have paid approximately $6.5 million extra in electricity costs as their share of LUS' cost of rail captivity. This $6.5 million from school budgets are funds that could obviously be more productively used in educational programs for students.

Besides the schools, I can also assure the Committee that fixed income families and retirees care deeply about these added monthly expenses, as do cost-conscious Lafayette businesses who are some of the largest consumers of LUS-produced electricity. The cost of captivity certainly matters and it has a substantial impact on Lafayette and our local economy. So contrary to some statements made by the rail companies, it is the electric residential and business consumer who pays 100 percent of all costs charged to us by the rail system, including premiums LUS is forced to pay due to rail captivity and those high costs have a direct impact on our community.

B. LUS Needs Effective Pro-Competitive Remedies to Protect Our Consumers

Something is clearly wrong with a legal system that allows railroads to extract huge captivity payments from bottleneck shippers. LUS needs meaningful pro-competitive remedies to protect its electricity consumers from this undue cost of captivity. Today, the railroads are exempt from many antitrust laws and the STB has already said it is fine for the UP to block LUS's access to competition through its ruling in the Bottleneck Decision.

LUS urges Congress to enact laws that encourage and require railroads to compete effectively and that accord rail shippers full legal recourse if railroads act in violation of the competition laws. For this reason, LUS supports H.R. 233, a bill designed and intended to bring the railroad industry into the 21st century by removing archaic antitrust "exemptions" that currently facilitate anticompetitive practices in the rail industry.

III. THE REMAINING RAILROAD ANTITRUST IMMUNITIES SHOULD BE REMOVED

Mr. Chairman, it seems extremely ironic that the railroads, whose abuses of market power in the late 1800's led to the enactment of our Nation's antitrust laws, are today exempt from many of those laws while their customers are subject to the Nation's antitrust laws. One must wonder why the railroads would oppose the removal of antitrust exemptions, unless they feel that the exemptions shield otherwise anticompetitive behavior as part of their conduct of business. Such a position by the railroads should by itself elevate sufficient suspicion to justify the passage of the H.R. 233. We think the railroad industry's exemptions from the antitrust laws are particularly unsupportable in light of the lack of competition that exists in the railroad coal transportation markets and the STB's failure to adopt regulatory policies that encourage railroads to compete.

A large coalition of interests shares our views and supports making railroads fully subject to the antitrust laws. This coalition includes the Antitrust Modernization Commission, the American Bar Association's Section of Antitrust Law, the Consumers Union, the Consumer Federation of America, numerous trade associations and 20 State Attorneys General.

We believe that the removal of the current railroad antitrust exemptions would be very beneficial to rail shippers. Hopefully, with the exemptions removed, the railroad industry would voluntarily stop anti-competitive practices such as refusing to quote upstream rates to bottleneck shippers. But, if such practices continue, shippers could pursue antitrust remedies free from the limitations currently imposed by the exemptions. We also believe that enactment of H.R. 233 should lead the STB to re-examine its Bottleneck Decision and reach a pro-competitive solution.

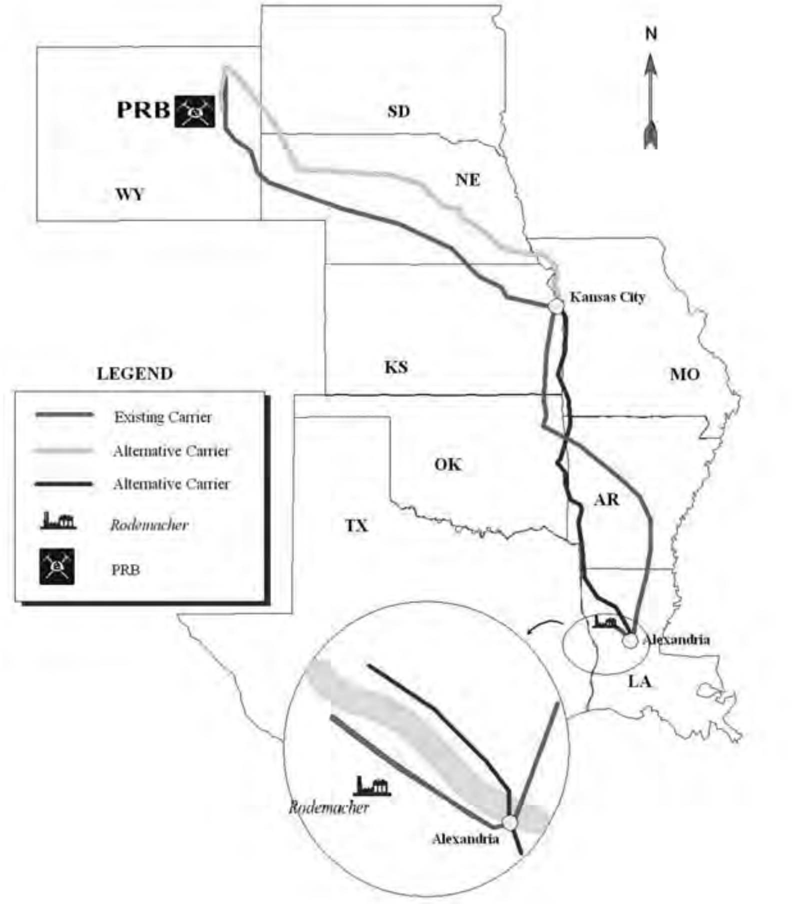
We understand that the removal of existing antitrust immunities enjoyed by the railroads may not alone completely address or resolve the remaining competitive problems in the railroad industry or those being experienced by LUS. That is why we believe complementary reform legislation is needed with regard to the STB and its policies, because, until the STB reverses anti-competitive decisions, Lafayette citizens and businesses will continue to financially suffer from rail monopoly abuse. Subjecting the railroads to the antitrust laws can only improve the dismal competitive climate that exists today in the coal transportation marketplace and should send a strong statement that the Congress believes that promoting competition, and not fostering anti-competitive protectionism, is the right thing to do and is in the public interest.

* * *

Mr. Chairman, thank you again for inviting me to testify. LUS commends H.R. 233 to your favorable attention and respectfully requests that the full Judiciary Committee favorably report the bill as soon as possible.

Attachment

Selected Routes For PRB Coal Moving to Rodemacher



Mr. JOHNSON. Thank you, Mr. Huval.

Dr. Cooper, your turn.

TESTIMONY OF MARK N. COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA, WASHINGTON, DC

Mr. COOPER. Thank you, Mr. Chairman, Members of the Committee. The Consumer Federation of America has been involved in public policy affecting the rail sector for 30 years for a simple reason: two-thirds of the coal shipped by rail is captive to a single railroad, and excessive coal rail rates end up in the electricity bills paid every month by American consumers. Excessive rail rates paid by other captive shippers of agriculture, chemical commodities, automobiles, industrial commodities distort the economy, lowering output and reducing employment.

The report we have filed for the record today demonstrates the pervasive abuse of market power that afflicts the rail sector. The vast majority of rail markets are highly concentrated. Abusing their market power, the railroads have accumulated billions of dollars of excess profits and cost subsidies on large quantities of traffic that they carry below cost. The current rail sector is a textbook case of abuse of market power run rampant, and we give about a dozen indicators of that in our analysis.

Combining the fact that we warned Congress this would happen before the Staggers Act was passed with the dramatic increase in abuse in the recent years, we conclude that as implemented by the Interstate Commerce Commission and the Surface Transportation Board, the Staggers Rail Act is among the first and worst examples of irrational exuberance for deregulation that has brought our economy to the brink of disaster.

We must reaffirm our commitment to competition and the prevention of the abuse of market power if we are to rebuild our economy. Enacting H.R. 233, the Railroad Antitrust Enforcement Act of 2009, is a perfect place to start.

The Staggers Rail Act is a particularly pernicious example of excessive deregulation because at the same time that Congress deregulated the rails, it also exempted the sector from the antitrust laws, entrusting the protection and promotion of competition to a regulatory agency that has been thoroughly captured by the industry it is supposed to oversee.

The result has been a double whammy for captive shippers and consumers. Over the objection of the Department of Justice, the STB has allowed the railroads to increase their market power through mergers and anticompetitive tactics while simultaneously failing to implement the residual regulation contained in the Staggers Act to prevent the abuse of market power.

Let us be clear: You can not look at what the STB and the ICC have done for a quarter of a century and say that this is a regulated industry. The regulator has been absent, irresponsible, and absolutely useless in terms of protecting shippers. That claim has zero credibility.

If this Congress and this Administration can not quickly restore the commitment to vibrant competition as the cornerstone of the American economy, we will be doomed as a Nation to economic mediocrity. All across the economy, Congress is beginning to repair the damage of accepted deregulation—in the financial sector, in the energy sector. But antitrust has a special place in our economy because it should affect and drive competition in all sectors.

Now, in some areas restoring the vitality of antitrust requires administrative action and court cases. Those will take a great deal of time. The rail sector is one area where Congress and quickly and decisively correct a mistake that Congress made.

We urge you to reverse that error and pass H.R. 233, which will restore antitrust scrutiny in the rail sector. This will eliminate artificial barriers to competition, called paper barriers, because they are a blatant affront—a contractual obligation not to compete—they are a blatant affront to the antitrust laws.

The threat of antitrust suits will also put pressure on railroads to behave more reasonably with respect to bottleneck facilities and reciprocal switching rates, as you have heard by the previous witness. Antitrust alone will not solve the problem of market power in the rail sector because the fabric of competition has been so severely damaged by more than a quarter of a century of neglect that we will need more. We will need regulation too.

But restoring antitrust oversight of this sector is a critical first step to addressing the problem of market power. We must use antitrust to drive competition as deeply as possible into our economy, and then rely on regulation where market power can not be addressed or where market failure is likely.

In the rail sector, we really do not know how far competition will carry us because it was never allowed to have a chance under the Staggers Act. Now is the time to give competition a chance and reform this industry as much as it is can, and then we will deal with regulation someplace else. Competition is the first thing we need to do to fix this sector.

Thank you.

[The prepared statement of Mr. Cooper follows:]

PREPARED STATEMENT OF MARK N. COOPER

CFA Consumer Federation of America

TESTIMONY OF DR. MARK COOPER
DIRECTOR OF RESEARCH

on the

RAILROAD ANTITRUST ENFORCEMENT ACT OF 2009

before the

JUDICIARY COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

May 19, 2009

Mr. Chairman and Members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America (CFA).[1] As described in the lengthy document attached to my testimony, CFA has been involved in public policy affecting the rail sector for almost thirty years. Our long-standing involvement stems from the fact that consumers shoulder the burden of excessive rail rates in the price of goods and services they consume, particularly electricity. Two thirds of the coal shipped by rail is captive to a single railroad and excessive coal rates end up in the electricity bills consumers pay every month. Excessive rail rates paid by captive shippers in other sectors, like agriculture and chemicals, distort the economy, lowering output and employment.

The report, entitled "Bulk Commodities and the Rails: Still Crazy After All these Years," also demonstrates the pervasive abuse of market power that afflicts the rail sector today. Today, the vast majority of rail markets are highly concentrated. Abusing their market power the railroads have accumulated billions of dollars of excess profits and cross subsidies on massive quantities of traffic that they carry at non-compensatory rates. Today the rail industry is a textbook case of market power run amok.

Combining the fact that we warned Congress this would happen even before the Staggers Act was passed, with the dramatic increase in abuse in recent years, we conclude that, as implemented by the Interstate Commerce Commission (ICC) and the Surface Transportation Board (STB), the Staggers Rail Act is among the first and worst examples of the irrational exuberance for deregulation that has brought our economy to the brink of disaster. We must reaffirm our commitment to competition and the prevention of the abuse of market power, if we are to rebuild our economy.

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[1] The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups with a membership of 50 million people founded in 1968 to advance consumers' interests through advocacy and education.

The Staggers Rail Act is a particularly pernicious example of excessive deregulation because at the same time that Congress deregulated the rails, it also exempted the sector from the antitrust laws, entrusting the protection and promotion of competition to a regulatory agency that is thoroughly captured by the industry it is supposed to oversee. The result has been a double whammy for captive shippers and consumers. The STB has allowed the railroads to increase their market power through mergers and anticompetitive tactics, while simultaneously failing to implement the residual regulation contained in the Staggers Act to prevent the abuse of that market power.

ABANDONING COMPETITION AND ANTITRUST

The failure of the ICC/STB to promote and protect competition in the rail sector is evident in three primary ways.

First, the ICC/STB allowed a merger wave to engulf the industry, reducing it from a state of vigorous competition, to a state of near monopoly. While some consolidation in the rail industry was certainly necessary, by the mid-1990s the benefits of consolidation had been captured. Over the opposition of the Department of Justice, the STB allowed mega-mergers to take place in the mid-1990s that rendered much of the nation captive to, at best, duopolies in the east and west. Vast swaths of America's heavy industries, raw materials and agricultural heartland are now captive to one or two railroads.

Second, the ICC/STB failed to implement the most fundamental principles of antitrust in connection with essential or "bottleneck" facilities. Captive shippers, who are within a few miles of a competitive alternative, are denied access to competition by the refusal of the railroads to allow movement of traffic that they monopolize to a competing railroad.

Third, to add insult to injury, the STB has allowed the railroads to erect paper barriers to competition. These are among the most blatantly anticompetitive contrivances that the U.S. government has allowed to be written into the routine practice of any sector in American history. As the mega-mergers were taking place, the dominant freight roads, desiring to specialize in the long haul transport of bulk commodities, found it convenient to spin-off short lines to service individual facilities or local areas. However, in order to ensure that the long haul freight railroads would be able to exploit their newly minted market power, the dominant railroads forced the new short lines to sign contracts that said in essence, "thou shalt not compete or do anything that promotes competition." Through these "paper barriers" the short lines are not allowed to traffic to or receive traffic from a competing major railroad.

In short the proposition that competition should be the organizing principle of economic activity in the rail sector – the principle upon which Congress enacted the Staggers Rail Act of 1980 - was abandoned by the ICC/STB.

THE FAILURE TO PROTECT CAPTIVE SHIPPERS

Having allowed the railroads to consolidate so dramatically, captive shippers implored the STB to exercise its regulatory authority to prevent the abuse of market power, but the STB turned a deaf ear.

First, the STB clings to a rate threshold that allows the railroads to charge exactly what the monopolist would charge. It allows the railroad to charge up to what it would cost the shipper to build his own stand-alone railroad at current costs. No other regulatory agency in American history has ever adopted this standard. To make matters worse, the burden is on the shipper to calculate the stand-alone cost, in a proceeding that can take years and cost millions of dollars.

Second, the STB has taken an approach to the calculation of the rate of return necessary for revenue adequacy that vastly overstates the railroads' need for revenue. The STB's weighted average cost of capital is one-fifth higher than the cost of capital calculated by Wall Street analysts. This inflated figure makes the railroads appear to be less profitable, thus encouraging a sympathetic STB to allow railroads to increase charges on their captives in pursuit of an absurdly high revenue target.

Third, the STB has failed to require that the railroads operate their business in an efficient manner. In particular, more than a quarter of a century after the passage of the Staggers Act, one fifth of all rail traffic does not cover its variable cost. In other words, there is a shortfall of $2 billion per year on a large part of rail traffic. If the railroads shed this traffic, their costs would go down by $2 billion. If they raised their rates to at least cover their direct costs, their revenues would go up by $2 billion. In either case, the railroads would be shown to be more than revenue adequate and, in theory, captive shipper rates would come down. The Long Cannon Amendment, which enabled the Staggers Act to gain passage in 1980 and was intended to prevent this type of abusive pricing, by requiring the railroads to maximize the contribution from competitive traffic, has been ignored by the STB.

POLICY RECOMMENDATIONS

If this Congress and this administration cannot quickly restore the commitment to vibrant competition as the cornerstone of American economic policy, we will be doomed as a nation to economic mediocrity. All across the economy Congress is beginning to repair the damage that excessive deregulation has done in the financial sector and the energy sector, but antitrust has a special place in American economic policy. It establishes the basic principle across all sectors. Since the Staggers Rail Act was one of the early examples of excessive deregulatory legislation early in the age of market fundamentalism, it is fitting for it to be among the first mistakes to be corrected.

In some areas restoring the vitality of antitrust requires administrative actions or court cases, which will take time. The rail sector is one area where Congress can act quickly and decisively to correct a mistake that Congress made. We urge you to reverse that error and pass H .R. 233, the "Railroad Antitrust Enforcement Act of 2009." Restoring antitrust scrutiny in the rail sector will eliminate paper barriers quickly because they are a blatant affront to the antitrust laws. The threat of antitrust action will also put pressure on the railroads to behave more reasonably with respect to bottleneck facilities and reciprocal switching rates.

However, antitrust alone will not solve the problem of market power in the rail sector because the fabric of competition has been so severely damaged by more than a quarter of a century of neglect. But restoring antitrust oversight of the sector is a critical first step in addressing the problem of market power. We must use antitrust to drive competition as deeply as possible into our economy and then rely on regulation where market power cannot be addressed or where market failure is likely. In the rail sector we really do not know how far competition will carry us because it was never allowed to operate under the implementation of the Staggers Act. The railroads preferred to pursue a monopoly path and the STB, and the ICC before it, was more than willing to aid and abet them. Now is the time to give competition a chance.

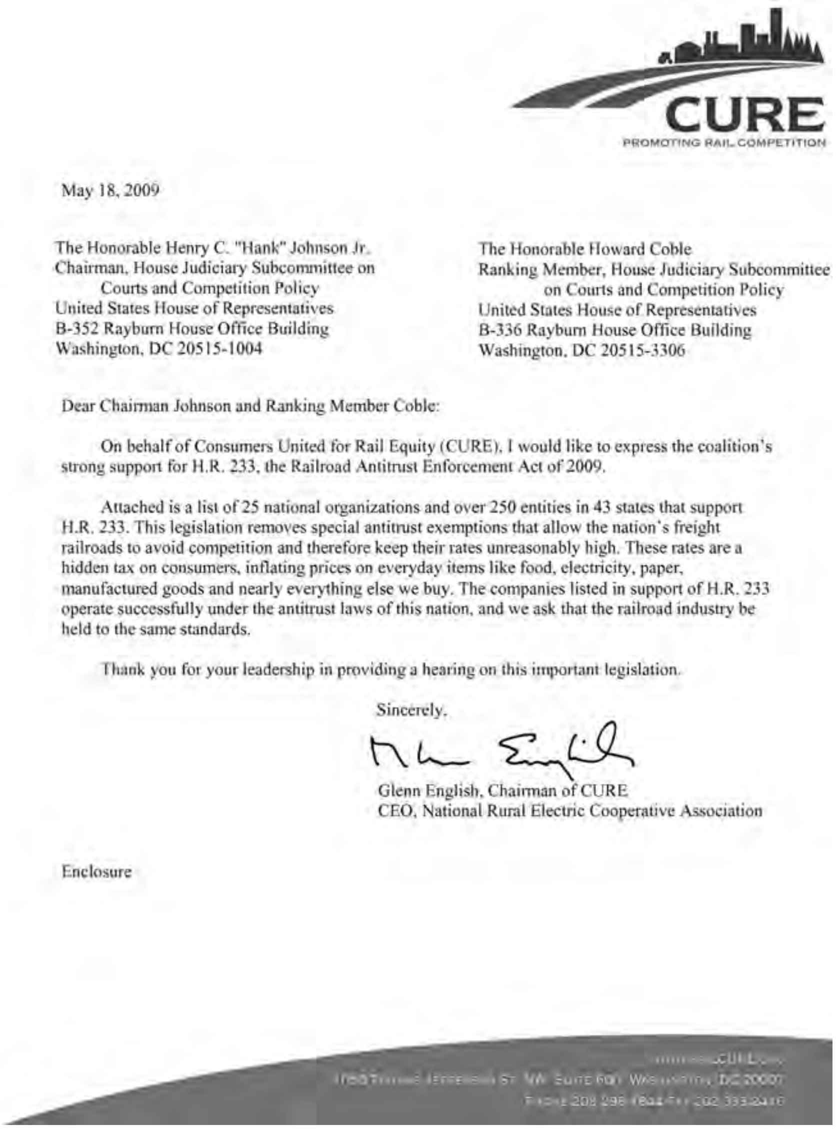
Mr. JOHNSON. Thank you, Dr. Cooper

We will now begin the questions, and I will recognize myself for 5 minutes.

For all of you, I would like to—well, prior to that, I would like to enter into the record a letter from—a letter to the Subcommittee signed by hundreds of companies across the country that ship their products by railroad. Any objection?

Without objection, it is so entered.

[The information referred to follows:]



CURE
PROMOTING RAIL COMPETITION

May 18, 2009

The Honorable Henry C. "Hank" Johnson Jr.
Chairman, House Judiciary Subcommittee on
Courts and Competition Policy
United States House of Representatives
B-352 Rayburn House Office Building
Washington, DC 20515-1004

The Honorable Howard Coble
Ranking Member, House Judiciary Subcommittee
on Courts and Competition Policy
United States House of Representatives
B-336 Rayburn House Office Building
Washington, DC 20515-3306

Dear Chairman Johnson and Ranking Member Coble:

On behalf of Consumers United for Rail Equity (CURE), I would like to express the coalition's strong support for H.R. 233, the Railroad Antitrust Enforcement Act of 2009.

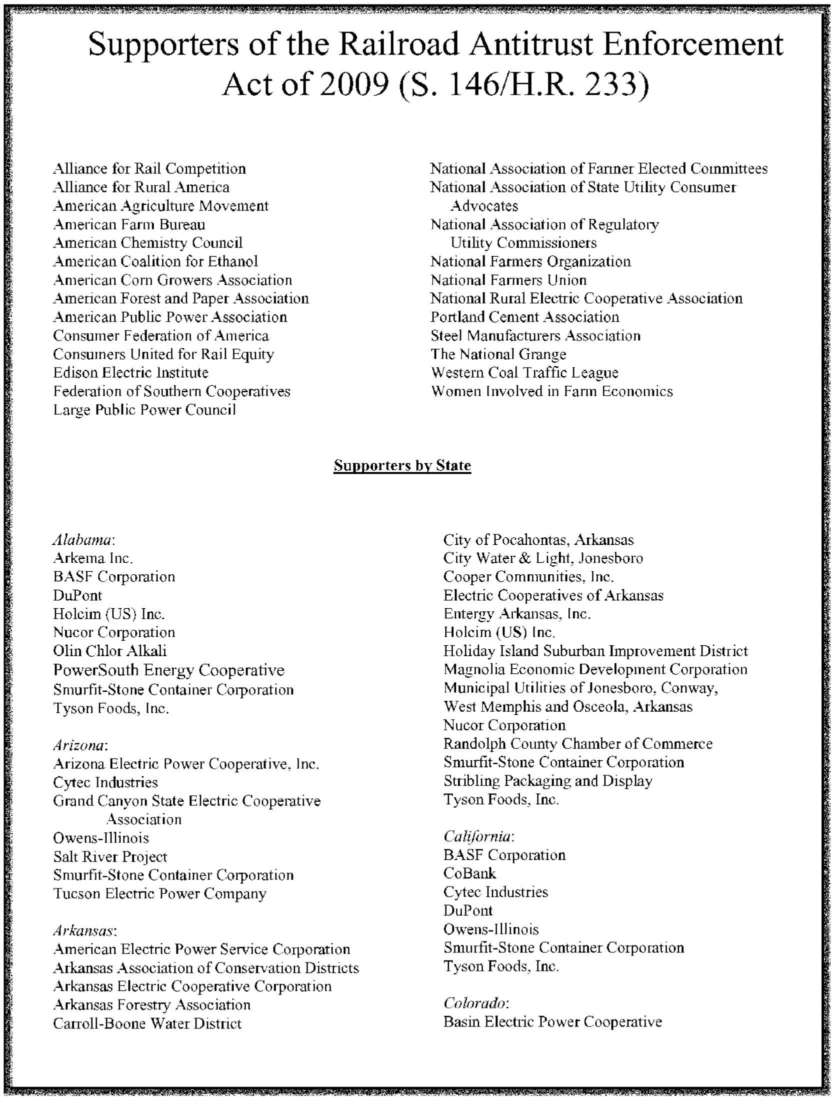
Attached is a list of 25 national organizations and over 250 entities in 43 states that support H.R. 233. This legislation removes special antitrust exemptions that allow the nation's freight railroads to avoid competition and therefore keep their rates unreasonably high. These rates are a hidden tax on consumers, inflating prices on everyday items like food, electricity, paper, manufactured goods and nearly everything else we buy. The companies listed in support of H.R. 233 operate successfully under the antitrust laws of this nation, and we ask that the railroad industry be held to the same standards.

Thank you for your leadership in providing a hearing on this important legislation.

Sincerely,

Glenn English, Chairman of CURE
CEO, National Rural Electric Cooperative Association

Enclosure



Supporters of the Railroad Antitrust Enforcement Act of 2009 (S. 146/H.R. 233)

Alliance for Rail Competition
Alliance for Rural America
American Agriculture Movement
American Farm Bureau
American Chemistry Council
American Coalition for Ethanol
American Corn Growers Association
American Forest and Paper Association
American Public Power Association
Consumer Federation of America
Consumers United for Rail Equity
Edison Electric Institute
Federation of Southern Cooperatives
Large Public Power Council
National Association of Farmer Elected Committees
National Association of State Utility Consumer Advocates
National Association of Regulatory Utility Commissioners
National Farmers Organization
National Farmers Union
National Rural Electric Cooperative Association
Portland Cement Association
Steel Manufacturers Association
The National Grange
Western Coal Traffic League
Women Involved in Farm Economics

Supporters by State

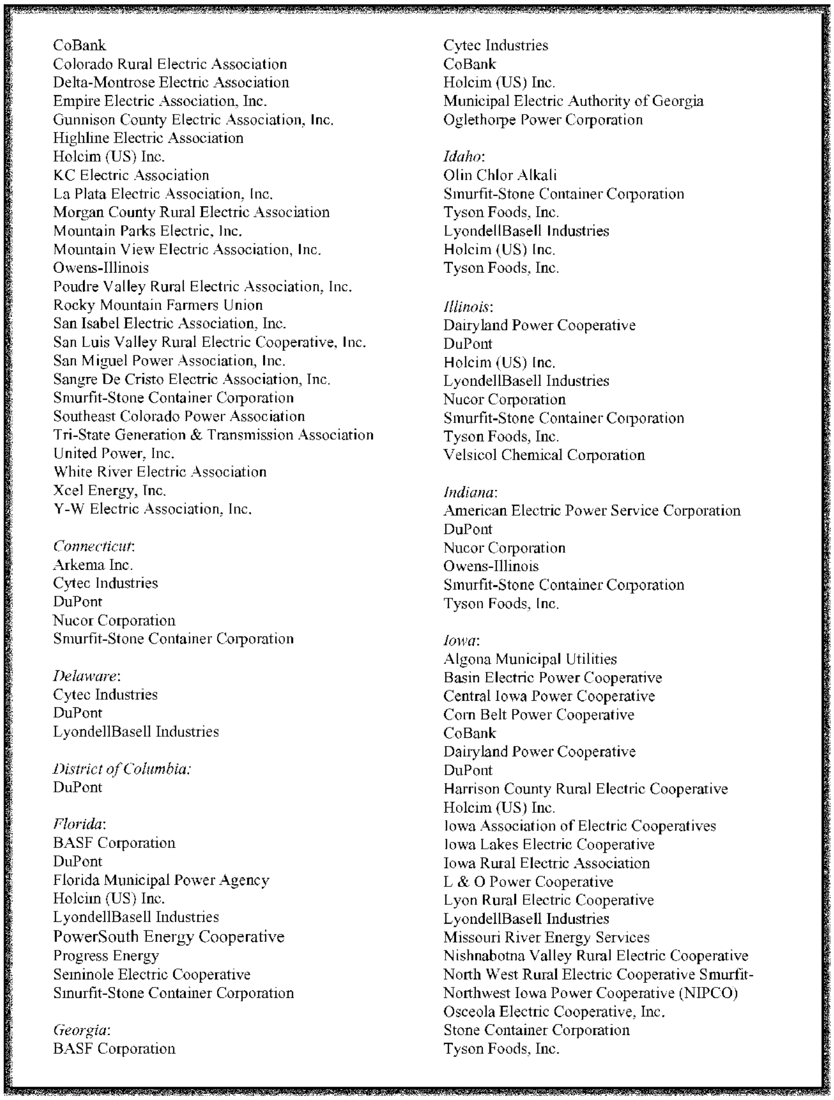
Alabama:
Arkema Inc.
BASF Corporation
DuPont
Holcim (US) Inc.
Nucor Corporation
Olin Chlor Alkali
PowerSouth Energy Cooperative
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

Arizona:
Arizona Electric Power Cooperative, Inc.
Cytec Industries
Grand Canyon State Electric Cooperative Association
Owens-Illinois
Salt River Project
Smurfit-Stone Container Corporation
Tucson Electric Power Company

Arkansas:
American Electric Power Service Corporation
Arkansas Association of Conservation Districts
Arkansas Electric Cooperative Corporation
Arkansas Forestry Association
Carroll-Boone Water District
City of Pocahontas, Arkansas
City Water & Light, Jonesboro
Cooper Communities, Inc.
Electric Cooperatives of Arkansas
Entergy Arkansas, Inc.
Holcim (US) Inc.
Holiday Island Suburban Improvement District
Magnolia Economic Development Corporation
Municipal Utilities of Jonesboro, Conway, West Memphis and Osceola, Arkansas
Nucor Corporation
Randolph County Chamber of Commerce
Smurfit-Stone Container Corporation
Stribling Packaging and Display
Tyson Foods, Inc.

California:
BASF Corporation
CoBank
Cytec Industries
DuPont
Owens-Illinois
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

Colorado:
Basin Electric Power Cooperative



CoBank
Colorado Rural Electric Association
Delta-Montrose Electric Association
Empire Electric Association, Inc.
Gunnison County Electric Association, Inc.
Highline Electric Association
Holcim (US) Inc.
KC Electric Association
La Plata Electric Association, Inc.
Morgan County Rural Electric Association
Mountain Parks Electric, Inc.
Mountain View Electric Association, Inc.
Owens-Illinois
Poudre Valley Rural Electric Association, Inc.
Rocky Mountain Farmers Union
San Isabel Electric Association, Inc.
San Luis Valley Rural Electric Cooperative, Inc.
San Miguel Power Association, Inc.
Sangre De Cristo Electric Association, Inc.
Smurfit-Stone Container Corporation
Southeast Colorado Power Association
Tri-State Generation & Transmission Association
United Power, Inc.
White River Electric Association
Xcel Energy, Inc.
Y-W Electric Association, Inc.

Connecticut:
Arkema Inc.
Cytec Industries
DuPont
Nucor Corporation
Smurfit-Stone Container Corporation

Delaware:
Cytec Industries
DuPont
LyondellBasell Industries

District of Columbia:
DuPont

Florida:
BASF Corporation
DuPont
Florida Municipal Power Agency
Holcim (US) Inc.
LyondellBasell Industries
PowerSouth Energy Cooperative
Progress Energy
Seminole Electric Cooperative
Smurfit-Stone Container Corporation

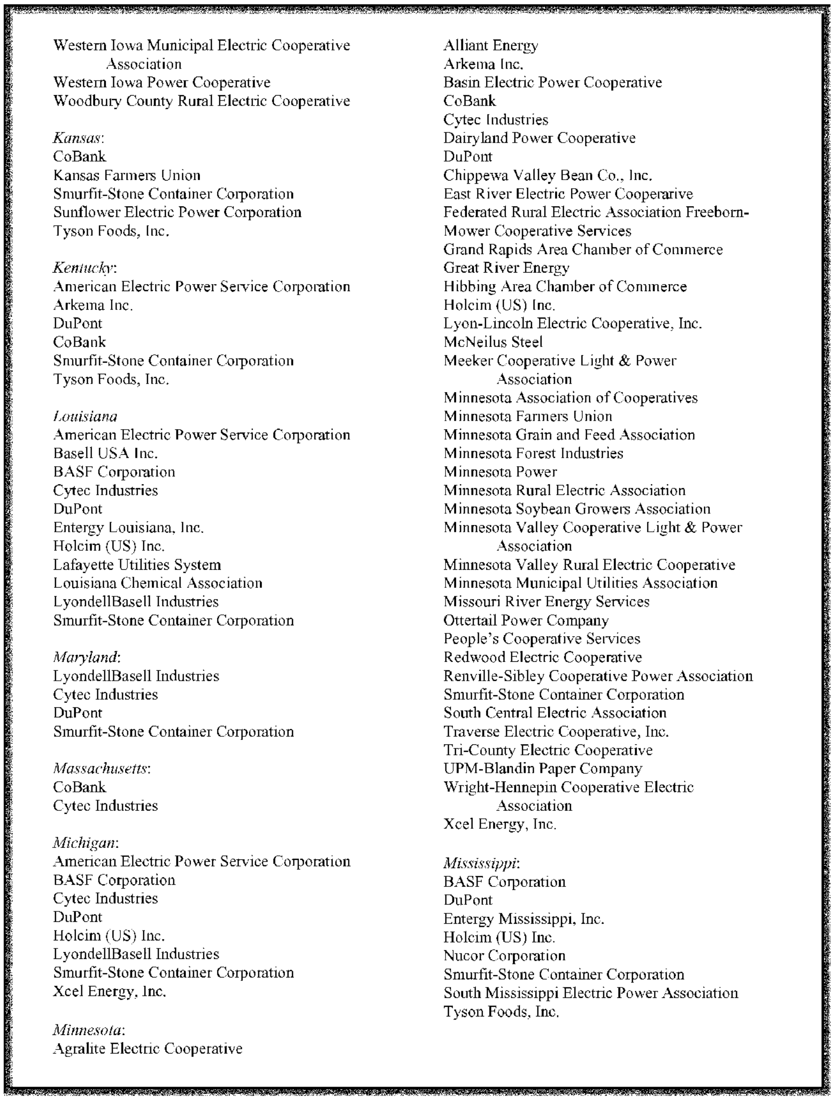
Georgia:
BASF Corporation
Cytec Industries
CoBank
Holcim (US) Inc.
Municipal Electric Authority of Georgia
Oglethorpe Power Corporation

Idaho:
Olin Chlor Alkali
Smurfit-Stone Container Corporation
Tyson Foods, Inc.
LyondellBasell Industries
Holcim (US) Inc.
Tyson Foods, Inc.

Illinois:
Dairyland Power Cooperative
DuPont
Holcim (US) Inc.
LyondellBasell Industries
Nucor Corporation
Smurfit-Stone Container Corporation
Tyson Foods, Inc.
Velsicol Chemical Corporation

Indiana:
American Electric Power Service Corporation
DuPont
Nucor Corporation
Owens-Illinois
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

Iowa:
Algona Municipal Utilities
Basin Electric Power Cooperative
Central Iowa Power Cooperative
Corn Belt Power Cooperative
CoBank
Dairyland Power Cooperative
DuPont
Harrison County Rural Electric Cooperative
Holcim (US) Inc.
Iowa Association of Electric Cooperatives
Iowa Lakes Electric Cooperative
Iowa Rural Electric Association
L & O Power Cooperative
Lyon Rural Electric Cooperative
LyondellBasell Industries
Missouri River Energy Services
Nishnabotna Valley Rural Electric Cooperative
North West Rural Electric Cooperative Smurfit-
Northwest Iowa Power Cooperative (NIPCO)
Osceola Electric Cooperative, Inc.
Stone Container Corporation
Tyson Foods, Inc.



Western Iowa Municipal Electric Cooperative Association
Western Iowa Power Cooperative
Woodbury County Rural Electric Cooperative

Kansas:
CoBank
Kansas Farmers Union
Smurfit-Stone Container Corporation
Sunflower Electric Power Corporation
Tyson Foods, Inc.

Kentucky:
American Electric Power Service Corporation
Arkema Inc.
DuPont
CoBank
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

Louisiana
American Electric Power Service Corporation
Basell USA Inc.
BASF Corporation
Cytec Industries
DuPont
Entergy Louisiana, Inc.
Holcim (US) Inc.
Lafayette Utilities System
Louisiana Chemical Association
LyondellBasell Industries
Smurfit-Stone Container Corporation

Maryland:
LyondellBasell Industries
Cytec Industries
DuPont
Smurfit-Stone Container Corporation

Massachusetts:
CoBank
Cytec Industries

Michigan:
American Electric Power Service Corporation
BASF Corporation
Cytec Industries
DuPont
Holcim (US) Inc.
LyondellBasell Industries
Smurfit-Stone Container Corporation
Xcel Energy, Inc.

Minnesota:
Agralite Electric Cooperative
Alliant Energy
Arkema Inc.
Basin Electric Power Cooperative
CoBank
Cytec Industries
Dairyland Power Cooperative
DuPont
Chippewa Valley Bean Co., Inc.
East River Electric Power Cooperarive
Federated Rural Electric Association Freeborn-Mower Cooperative Services
Grand Rapids Area Chamber of Commerce
Great River Energy
Hibbing Area Chamber of Commerce
Holcim (US) Inc.
Lyon-Lincoln Electric Cooperative, Inc.
McNeilus Steel
Meeker Cooperative Light & Power Association
Minnesota Association of Cooperatives
Minnesota Farmers Union
Minnesota Grain and Feed Association
Minnesota Forest Industries
Minnesota Power
Minnesota Rural Electric Association
Minnesota Soybean Growers Association
Minnesota Valley Cooperative Light & Power Association
Minnesota Valley Rural Electric Cooperative
Minnesota Municipal Utilities Association
Missouri River Energy Services
Ottertail Power Company
People's Cooperative Services
Redwood Electric Cooperative
Renville-Sibley Cooperative Power Association
Smurfit-Stone Container Corporation
South Central Electric Association
Traverse Electric Cooperative, Inc.
Tri-County Electric Cooperative
UPM-Blandin Paper Company
Wright-Hennepin Cooperative Electric Association
Xcel Energy, Inc.

Mississippi:
BASF Corporation
DuPont
Entergy Mississippi, Inc.
Holcim (US) Inc.
Nucor Corporation
Smurfit-Stone Container Corporation
South Mississippi Electric Power Association
Tyson Foods, Inc.

Missouri:
BASF Corporation
CoBank
Holcim (US) Inc.
Smurfit-Stone Container Corporation
Tyson Foods, Inc.
Upper Missouri G&T Electric Cooperative, Inc.

Montana:
Basin Electric Power Cooperative
Big Flat Electric Cooperative, Inc.
Central Montana Electric Power Cooperative, Inc.
Flathead Electric Cooperative, Inc.
Goldenwest Electric Cooperative, Inc.
Hill County Electric Cooperative, Inc.
Holcim (US) Inc.
Lower Yellowstone Rural Electric Association, Inc.
Marias River Electric Cooperative, Inc.
McCone Electric Cooperative, Inc.
Montana-Dakota Utilities
Montana Electric Cooperatives' Association
Northern Electric Cooperative, Inc.
Park Electric Cooperative, Inc.
Sheridan Electric Cooperative, Inc.
Smurfit-Stone Container Corporation
Southeast Electric Cooperative, Inc.
Sun River Electric Cooperative, Inc.
Valley Electric Cooperative, Inc.

Nebraska:
Basin Electric Power Cooperative
Chimney Rock Public Power District
CoBank
DuPont
Holcim (US) Inc.
Lincoln Electric System
The Midwest Electric Cooperative Corporation
Nebraska Rural Electric Association
Northwest Rural Public Power District
Nucor Corporation
Panhandle Rural Electric Membership Association
Roosevelt Public Power District
Tyson Foods, Inc.
Wheat Belt Public Power District

Nevada:
Smurfit-Stone Container Corporation

New Jersey:
BASF Corporation
Cytec Industries
DuPont
LyondellBasell Industries
Smurfit-Stone Container Corporation

New Mexico:
Basin Electric Power Cooperative
Central New Mexico Electric Cooperative, Inc.
Columbus Electric Cooperative, Inc.
Jemez Mountains Electric Cooperative, Inc.
Kit Carson Electric Cooperative, Inc.
New Mexico Rural Electric Cooperative Association
Northern Rio Arriba Electric Cooperative, Inc.
Rocky Mountain Farmers Union
Sierra Electric Cooperative, Inc.
Springer Electric Cooperative, Inc.
Tyson Foods, Inc.
Xcel Energy, Inc.

New York:
Arkema Inc.
CEMEX, INC.
Cytec Industries
DuPont
Nucor Corporation
Olin Chlor Alkali
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

North Carolina:
BASF Corporation
Cytec Industries
DuPont
Holcim (US) Inc.
North Carolina Electric Membership Corporation
Nucor Corporation
Progress Energy
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

North Dakota:
Basin Electric Power Cooperative
Burke-Divide Electric Cooperative, Inc.
Capital Electric Cooperative Inc.
Central Power Electric Cooperative, Inc.
CoBank
Dakota Valley Electric Cooperative, Inc.
KEM Electric Cooperative, Inc.
McKenzie Electric Cooperative, Inc.
McLean Electric Cooperative, Inc.
McNeilus Steel
Missouri River Energy Services
Montana-Dakota Utilities
Mor-Gran-Sou Electric Cooperative, Inc.
Mountrail-Williams Electric Cooperative
North Central Electric Cooperative, Inc.
North Dakota Association of Rural Electric Cooperatives
Northern Plains Electric Cooperative

Oliver-Mercer Electric Cooperative, Inc.
Slope Electric Cooperative, Inc.
Smurfit-Stone Container Corporation
Verendrye Electric Cooperative, Inc.
Xcel Energy, Inc.

Ohio:
American Electric Power Service Corporation
BASF Corporation
DuPont
Holcim (US) Inc.
Nucor Corporation
Ohio Farmers Union
Ohio Municipal Electric Association
Owens-Illinois
LyondellBasell Industries
Smurfit-Stone Container Corporation

Oklahoma:
American Electric Power Service Corporation
DuPont
Holcim (US) Inc.
Oklahoma Farmers Union
Western Farmers Electric Cooperative

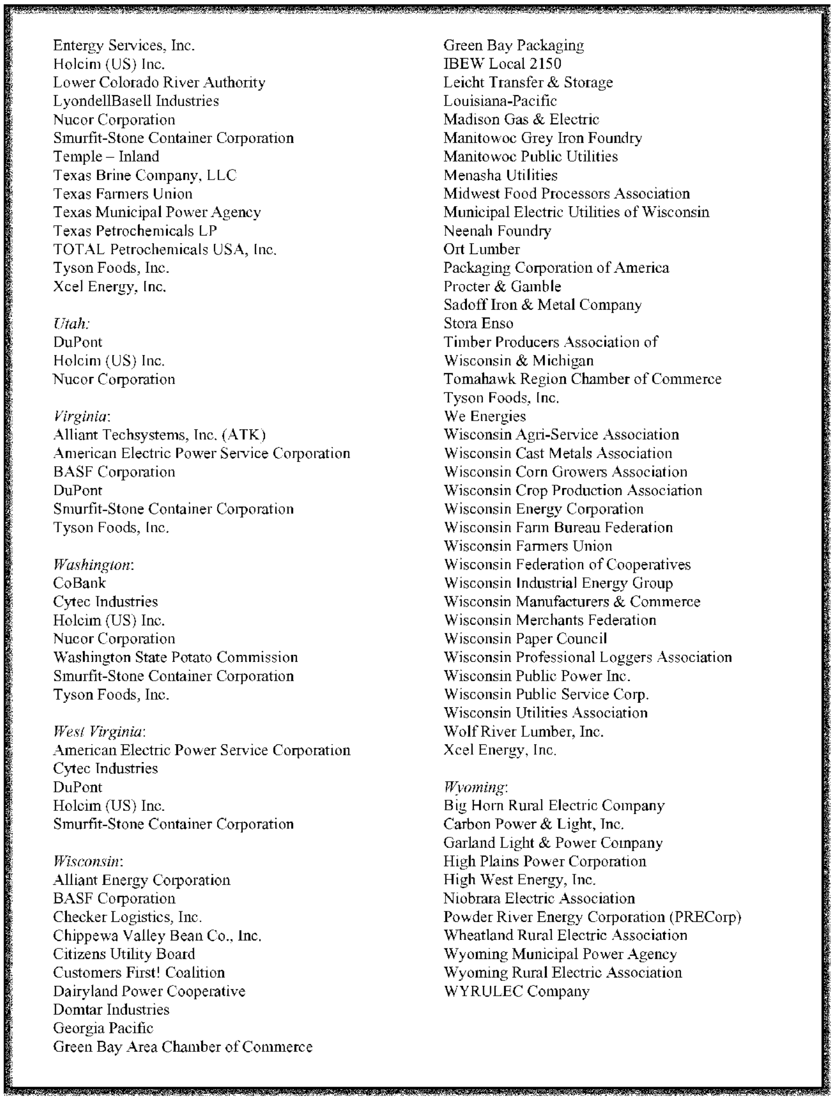
Pennsylvania:
Arkema Inc.
BASF Corporation
DuPont
LyondellBasell Industries
Pennsylvania Farmers Union
PPL Corporation
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

South Carolina:
BASF Corporation
Cytec Industries
DuPont
Holcim (US) Inc.
Nucor Corporation
Progress Energy
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

South Dakota:
Basin Electric Power Cooperative
Black Hills Electric Cooperative, Inc.
Bon Homme Yankton Electric Association, Inc.
Butte Electric Cooperative, Inc.
Cam Wal Electric Cooperative, Inc.
Central Electric Cooperative, Inc.
Charles Mix Electric Association, Inc.
Cherry-Todd Electric Cooperative, Inc.
City of Elk Point
Clay Union Electric Corporation
Codington-Clark Electric Cooperative, Inc.
Dakota Energy Cooperative, Inc.
Douglas Electric Cooperative, Inc.
East River Electric Power Cooperative, Inc.
FEM Electric Association, Inc.
Grand Electric Cooperative, Inc.
H-D Electric Cooperative, Inc
Kingsbury Electric Cooperative Inc
Lacreek Electric Association, Inc.
Lake Region Electric Association, Inc.
Missouri River Energy Services
Montana-Dakota Utilities
Moreau-Grand Electric Cooperative, Inc.
Northern Electric Cooperative, Inc.
Oahe Electric Cooperative, Inc.
Rosebud Electric Cooperative, Inc.
Rushmore Electric Power Cooperative, Inc.
Sioux Valley Energy
Smurfit-Stone Container Corporation
South Dakota Rural Electric Association
Southeastern Electric Cooperative, Inc.
Union County Electric Cooperative, Inc.
West Central Electric Cooperative, Inc.
West River Electric Association, Inc.
Whetstone Valley Electric Cooperative, Inc.
Tyson Foods, Inc.
Xcel Energy, Inc.

Tennessee:
American Electric Power Service Corporation
Arkema Inc.
LyondellBasell Industries
BASF Corporation
Cytec Industries
DuPont
Holcim (US) Inc.
LyondellBasell Industries
Nucor Corporation
Olin Chlor Alkali
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

Texas:
American Electric Power Service Corporation
Arkema Inc.
Association of Electric Companies of Texas
LyondellBasell Industries
BASF Corporation
CEMEX INC.
CoBank
City of Austin/Austin Energy
Cytec Industries
DuPont
East Texas Cooperatives



Entergy Services, Inc.
Holcim (US) Inc.
Lower Colorado River Authority
LyondellBasell Industries
Nucor Corporation
Smurfit-Stone Container Corporation
Temple – Inland
Texas Brine Company, LLC
Texas Farmers Union
Texas Municipal Power Agency
Texas Petrochemicals LP
TOTAL Petrochemicals USA, Inc.
Tyson Foods, Inc.
Xcel Energy, Inc.

Utah:
DuPont
Holcim (US) Inc.
Nucor Corporation

Virginia:
Alliant Techsystems, Inc. (ATK)
American Electric Power Service Corporation
BASF Corporation
DuPont
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

Washington:
CoBank
Cytec Industries
Holcim (US) Inc.
Nucor Corporation
Washington State Potato Commission
Smurfit-Stone Container Corporation
Tyson Foods, Inc.

West Virginia:
American Electric Power Service Corporation
Cytec Industries
DuPont
Holcim (US) Inc.
Smurfit-Stone Container Corporation

Wisconsin:
Alliant Energy Corporation
BASF Corporation
Checker Logistics, Inc.
Chippewa Valley Bean Co., Inc.
Citizens Utility Board
Customers First! Coalition
Dairyland Power Cooperative
Domtar Industries
Georgia Pacific
Green Bay Area Chamber of Commerce
Green Bay Packaging
IBEW Local 2150
Leicht Transfer & Storage
Louisiana-Pacific
Madison Gas & Electric
Manitowoc Grey Iron Foundry
Manitowoc Public Utilities
Menasha Utilities
Midwest Food Processors Association
Municipal Electric Utilities of Wisconsin
Neenah Foundry
Ort Lumber
Packaging Corporation of America
Procter & Gamble
Sadoff Iron & Metal Company
Stora Enso
Timber Producers Association of
Wisconsin & Michigan
Tomahawk Region Chamber of Commerce
Tyson Foods, Inc.
We Energies
Wisconsin Agri-Service Association
Wisconsin Cast Metals Association
Wisconsin Corn Growers Association
Wisconsin Crop Production Association
Wisconsin Energy Corporation
Wisconsin Farm Bureau Federation
Wisconsin Farmers Union
Wisconsin Federation of Cooperatives
Wisconsin Industrial Energy Group
Wisconsin Manufacturers & Commerce
Wisconsin Merchants Federation
Wisconsin Paper Council
Wisconsin Professional Loggers Association
Wisconsin Public Power Inc.
Wisconsin Public Service Corp.
Wisconsin Utilities Association
Wolf River Lumber, Inc.
Xcel Energy, Inc.

Wyoming:
Big Horn Rural Electric Company
Carbon Power & Light, Inc.
Garland Light & Power Company
High Plains Power Corporation
High West Energy, Inc.
Niobrara Electric Association
Powder River Energy Corporation (PRECorp)
Wheatland Rural Electric Association
Wyoming Municipal Power Agency
Wyoming Rural Electric Association
WYRULEC Company

Mr. JOHNSON. These companies believe that the antitrust exemptions are raising their costs, which, in turn, raise the prices that consumers have to pay. Is there anything that makes railroads different from any other industry that should make us hesitate before applying antitrust laws?

Anybody who wished to respond, please do.

Mr. HUVAL. This is Terry Huval. No, I don't see any reason why, you know, the railroads should be exempt from any of the antitrust laws that many other industries must deal with, in the utilities business—whether you are in the electric business or the gas business—you have regulation and you have to abide by the antitrust laws. So we think that ought to be uniform and we think that that type of umbrella requirement the railroad companies would create a different behavior on how they deal with customers like Lafayette.

Mr. HEMMER. If I may, I have already pointed out that in many respects H.R. 233 would treat Union Pacific and other major railroads differently than other regulated industries. So we would like to at least start with the proposition that you should treat us the same way other regulated industries are treated.

Are there unique characteristics of the railroad industry that make them appropriate for antitrust exemptions? Well, given the fact that I have already told you that we would be relatively untroubled by eliminating the statutory exemptions I am not going to make that claim. What you have to look at, though, and what would be looked at by any antitrust court looking at any regulated or partially regulated industry is, what is the structure of that regulation and how does that regulation interact with an antitrust court's jurisdiction?

We would expect to be accorded the same treatment. My colleague on the right said something very important. He said the implied immunity doctrine would still apply to railroads.

I am very concerned, especially given the legislative history that was prepared for last year's bill, that this Committee was instructing courts not to apply the implied immunity doctrine. So if I had some reassurance about that—again, about equal treatment with other regulated industries—I would feel more comfortable.

Mr. COOPER. The suggestion that regulation has somehow—should be accorded any credibility in this industry is literally absurd. You can go back over 25-year history and look at the number of cases that shippers have won and you can count them on one hand, and then you will look at the relief they got and you will discover that the hand was just slapping them in the face. There is literally no notion that there is regulation of rates over captive shippers whatsoever.

So that leads to the reason why there may be an effort to look back a little bit, because we have had a 25-year history of the rampant exercise of market power under a lack of regulation and a lack of competition and a lack of antitrust oversight. And so you combine that 25-year history with an incredible increase in profitability in rates in the last few years, a tightness of capacity, and the answer is that this is an old problem, and I worked on the Staggers Act as it went through this Congress, and we knew this could happen, and it has happened.

You can look at the mergers of the mid-1990's—a tremendous increase in market power. The Department of Justice opposed those mergers. That is anticompetitive, and the out—the result has been abuse of market power.

So yes, we have to look back to try and unravel a quarter of a century of abuse.

Mr. HEMMER. Mr. Chairman, if I may try to unravel some of the misstatements that were just made, the Surface——

Mr. JOHNSON. Well, Mr. Hemmer, I really don't want us to get into a debate on this, so I would appreciate your forbearance.

Mr. Cooper, by removing the railroad industry's antitrust exemptions, how much do you think we could save consumers every year?

Mr. COOPER. Well, we have estimated a total figure that we see as abuse—a combination of excess profit and cost subsidy. It is remarkable after a quarter of a century that so much traffic is carried on the rail that doesn't cover its costs. We think there are $3 billion or more of abuse.

How much would come out from any particular decision, you can not predict. And the point is that, in a certain sense, that is the magic of real competition. If you let competition reign, if you tear up those paper barriers, if you put pressure on these bottleneck decisions that frustrate competition that could take place over 99 percent of a movement, you—shippers will get lower rates, railroads will be more efficient, and the economy will be better off.

I can't put a dollar figure on any particular decision. It is the principle of competition that we really need to get back to. The competitive marketplace will sort that out.

Lafayette, Louisiana will get a fair rate because they have an alternative. There are many power plants in America that don't have this situation of 99 percent potential competition and 1 percent bottleneck. Some of those are 100 percent monopolies, and those rates will be decided not in the competitive marketplace, but they should be overseen by the Surface Transportation Board.

Mr. JOHNSON. Thank you, sir.

And last but not least, this question: Mr. Hemmer, in his written testimony, argues that courts are incapable of evaluating the network effects of applying the antitrust laws to bottleneck situations. How would you respond, Mr. Morse?

Mr. MORSE. I think we have seen—let me make clear, I am not sure that the antitrust section has addressed that position in its testimony, so let me address it personally in answer to your question. I think we have seen the benefits of competition in other industry when interconnections have been opened up.

There was a long time when we viewed the telephone industry in this country as a monopoly and we were told that we could not interconnect and connect our personal telephones or other devices within our home to the telephone network for fear that it would cause the entire network to fall apart. As we have seen competition increase in the telecommunications industry, in those areas where competition can flourish, we have seen tremendous benefits to consumers.

Mr. JOHNSON. All right. We appreciate that.

I will now recognize the Ranking Member for his questions.

Mr. COBLE. Thank you, Mr. Chairman.

And gentlemen, thank you for being here. We only have 5 minutes, so let me move along.

Mr. Hemmer, it is your belief that H.R. 233 is retroactive and that past mergers could be contested in the future by the Justice Department or FTC. Explain to us how that would be problematic for the railroads, A, for shippers, B, and how it would impact consumers.

Mr. HEMMER. Well, transactions that have been approved in the past have been fully implemented. Operations of network industries have been fully combined. You can no longer distinguish, in my case, the Missouri Pacific from the Union Pacific from the Western Pacific, all of which were combined back in 1980.

If an antitrust court were attempt—to attempt to disassemble various parts or segments of that network, we would have a chaotic situation that would take years to unravel. You may recall, and I confess, that following the Union Pacific-Southern Pacific merger there were service disruptions. Those would be modest compared to the disruption that would occur if we were to attempt to untangle the railroad system that has been operating as a single system for decades.

Mr. COBLE. Mr. Morse, what competitive standard will be used by the Justice Department if, in fact, 233 is enacted, and how would that standard differ from the one currently used by STB?

Mr. MORSE. Congressman, I am not a railroad regulatory expert, and therefore am not in a position to address the question of how the STB regulates. I have read the testimony that indicates that the STB, with respect to some of these issues with respect to bottleneck rates, for instance, with the STB, does allow the railroads to quote rates for the entire distance. And I believe that antitrust, in approaching that issue, would look at that as a tying question, would question whether a firm has market power in one market and is using that market power to foreclose competition in a second market and might condemn those arrangements in those circumstances where there is market power and a tying agreement.

Mr. COBLE. Thank you, sir.

Dr. Cooper, would you oppose an amendment clarifying that past mergers would continue to remain exempt from challenges by the FTC or the Justice Department—and as briefly as you can, because I am running out of time.

Mr. COOPER. That would be an extraordinary exemption from the antitrust laws. The fascinating thing, as you heard, the mention of the AT&T case, and that was—their exact argument was, “You can’t break us up.” Why? The network will collapse. And my god, 20 years later we are a lot better off for having had competition.

So the question here is that if the Department of Justice looks at that monopoly situation and discovers that market power is being abused, they could well take action against that far short of requiring divestiture. They might look upon the paper barriers as illegal restraints on trade and have those removed; they might look at the refusal to deal, in terms of bottleneck facilities, and have those be eliminated. So those are actions that ought to be allowed when the Department of Justice examines a monopoly.

Mr. COBLE. Okay. I don’t want to omit Mr. Huval. Let me bring him in as my cleanup hitter.

Mr. Huval, I am been told and I think it has been aired today, that in certain instances some electric companies have found it to be less effective to ship foreign oil into the United States by a barge rather than shipping domestic coal by railroads to points within this country. Is this a common conclusion?

Mr. HUVAL. We would by far prefer having all of our energy sources come from this country versus having to ship it from abroad.

Mr. COBLE. Mr. Chairman, not unlike Mr. Morse, I have beat the red light.

Mr. JOHNSON. Thank you, Mr. Coble,

And I would just admonish everyone that don't—no spontaneous outbursts will be done here today, and if they are then they will be treated very harshly, even though they may be based on your irrational exuberance, Dr. Cooper, and anyone else that may find themselves afflicted with this urge.

We will now begin with our questions by the Members. First, Congressman Mel Watt, North Carolina.

Mr. WATT. Thank you, Mr. Chairman. And thank you for convening this important hearing, which, for some of us, has given us an opportunity to focus on this issue for the first time. I have two concerns that I want to explore, and I will explore them with Mr. Hemmer and Mr. Morse, since they seem to be on opposite sides of them.

Mr. Hemmer, you suggested that section nine of the bill allows this bill to be applied retroactively. Can you concisely give me an example of how that might play out, and without getting into a debate, which the Chairman said he didn't want to encourage, I would like to have Mr. Morse respond to whatever situation you describe. So describe your best situation where you think this would be retroactive.

I take it Dr. Cooper wants it to be retroactive. I am a little concerned about retroactivity when we are writing laws and applying them.

So give us an example of where and how you believe section nine would make this—allow this to be retroactive.

And then, Mr. Morse, if you can respond to Mr. Hemmer's example, that would be helpful to me, just to frame the issue here.

Mr. HEMMER. I actually thought Mr. Morse and I were getting along reasonably well. I believe that section nine establishes two requirements for limitations. Basically, it says that conduct that takes place within the first 180 days after passage of the act and that has been immunized from the antitrust laws can not be challenged. However, conduct that takes place after the 180th day, which is essentially the continued implementation and carrying out of all of those immunized transactions, would be subject to attack.

To take a specific example, when Union Pacific and Southern Pacific railroads merged, they formed a very efficient, now extremely competitive, single-line route across the southern tier of the United States, from Los Angeles into Texas and other points beyond. On the 181st day, I am fearful that someone might say, "The Surface Transportation Board's creation and authorization of that route can now be attacked under the antitrust law."

Mr. WATT. Let me be clear on that. If we changed the word "and" to "or," would that solve that problem?

Mr. HEMMER. I believe it goes a long way toward doing that, but I would want to look very carefully at the language to make sure that it would.

Mr. WATT. Mr. Morse?

Mr. MORSE. Actually, as Mr. Hemmer said, we don't quite disagree so much on some of these issues. Let me be clear: In our testimony——

Mr. WATT. Do you agree with Dr. Cooper that you intend for it to be retroactive?

Mr. MORSE. I may take a middle ground between them. And what our testimony said is, we said that we thought that the House bill takes a more sound approach than the Senate bill, with respect to this issue.

I read the Senate bill as potentially opening up the issue that Mr. Hemmer identified, because it talks about previously exempted agreements. The House bill, as I read it, only talks about ongoing conduct. I am not sure——

Mr. WATT. Would it do injustice to change the word "and" to "or" on page seven, line seven of the bill?

Mr. MORSE. I think I would want to look at that——

Mr. WATT. If you all could look at that and give me something in writing on that. Let me go on——

Mr. MORSE. Let me make one point, though, with respect to this, and that is, I do see a difference with respect to mergers and with respect to the paper barrier issue, simply because there was a divestiture or trackage at some point in time. But let me be clear: I don't think the antitrust section does not believe that previously consummated mergers should be subject to challenge. But at least looking at the question of a paper barrier, where you had a divestiture of trackage, if that included an agreement that would permanently prohibit competition——

Mr. WATT. I understand that.

Mr. MORSE [continuing]. Then to allow that continued prohibition on competition is a different situation than the merger situation.

Mr. WATT. My time has run out, Mr. Chairman, but if I could just ask the other question for them to respond to in writing, it would be helpful.

Mr. JOHNSON. Proceed.

Mr. WATT. The other thing that I have some concern about was the prospect of inconsistent liability and outcomes if you have various folks along in various jurisdictions interpreting the statute. And so I would like any of you who care to to give me something in writing on that, and whether that might be addressed by—instead of giving the final authority to the STB, perhaps giving jurisdiction over these disputes to one particular court as the ultimate auditor, so that we don't end up with courts in different parts of the country reaching results on essentially the same facts that are inconsistent with each other. I know we don't have time for the witnesses to respond, but if you could do that in writing that would be wonderful, and I will be happy to put it in the record if you will address it to me.

I thank the Chairman for his indulgence and yield back.

Mr. JOHNSON. Certainly. Thank you, Congressman Watt.

Next we will have questions from Bob Goodlatte, of the great state of Virginia.

Mr. GOODLATTE. Thank you, Mr. Chairman.

And I want to thank all of the witnesses. I would like to pick up right where the gentleman from North Carolina left off and give you an answer—give you an opportunity to answer the very question that he just asked——

Mr. JOHNSON. Can you speak into the microphone? I can barely hear you——

Mr. GOODLATTE. This microphone doesn't tilt in the right direction. There we go.

If you could follow up and address—I will ask each of you to do that—how we would handle the issue of the fact that these rail lines do transcend not just district court boundaries, but even Federal court of appeal jurisdiction boundaries. How is a railroad to behave when they have three different decisions from three different jurisdictions instruct them how to act?

Mr. MORSE. Let me say, I think that is the nature of the judicial system that we live in. Many of my clients in many industries face the possibility of being in court in different parts of the country. We give advice to clients on how to comply with the law based on the fact that we have different circuits sometimes coming up.

When you actually end up in litigation, generally we tend to see courts at least listening to what other courts have said, but I don't think that is an issue which would confront the railroad industry different than it confronts every other industry in the——

Mr. GOODLATTE [continuing]. In some respects. I mean, there are certain types of industries where you can, and many industries do, operate in different fashions in different jurisdictions. The insurance industry operates differently regulated by each state insurance commissioner, and they can tailor that.

But when you are shipping the same goods along the same line between the same communities and you are only operating along that line, you could have conflicting opinions that affect the same transaction, as opposed to two transactions engaged in by the same company but in different places.

So I don't know if you want to add to that, or I will just turn to Mr. Hemmer and see what reflection he can give on that.

Mr. HEMMER. Let me note at the outset that the railroad industry faces a more complex situation, which is typical of regulated industries, in that we may have one standard of performance established by the Surface Transportation Board and conflicting standards of performance under this bill set by the FTC and potentially by courts, whether they are in different parts of the country or sitting right next to each other.

Mr. GOODLATTE. Well, that is my next question, which is what you do when you have a conflict between a court decision and the Surface Transportation Board. Does this legislation tell us the answer to that?

Mr. HEMMER. The legislation, in my view, doesn't clearly instruct a court about what to do. With respect to so-called paper barriers and so-called bottleneck rates, the legislative history virtually tells a court what to do and it, in my view, tells it to ignore several doctrines of antitrust jurisprudence that would normally apply in deciding what the relationship is between the court and the regulatory agency. That is a major concern for us, and if we could get that cleared up that would make a big difference.

So I think we might find courts not knowing how to interact with regulation, whereas, for decades they have had basic standards, such as primary jurisdictions, implied immunity—modified recently by the Credit Suisse decision—and they can apply those things. We know the standards and they know the standards. I believe this bill creates significant confusion.

Mr. GOODLATTE. Dr. Cooper?

Mr. COOPER. Well, ultimately, in America we have federalism. And in the court system we do get conflicts between the courts, and they get resolved, when there is a conflict, through the court system. And we do get uniformity. And that takes time, but that is the process that we have in this country for resolving those judicial outcomes. And frankly, we are frequently proud of that federalism——

Mr. GOODLATTE. Let me ask you, Dr. Cooper, would you—with this legislation would you preserve the Surface Transportation Board—or if you are going to go to a system where you can have legal action and Federal Trade Commission supervision, do you also need the Surface Transportation Board, or can you go with one or the other?

Mr. COOPER. No. The simple fact of the matter is that there is pervasive market power in this industry, as several other industries, and we, as a Nation, have actually had both antitrust and regulation. The problem here is that we didn't have antitrust, and so we don't know how far antitrust can carry us.

And some of the most important antitrust cases have, in fact, been in regulated industries—in the electric utility industry ottertails require the integrated grid. And believe me, an electric utility system is a lot more integrated than a railroad system; electrons are more difficult. Second of all, AT&T—antitrust cases take place in regulated industries, and by introducing competition we are much better off for it.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. JOHNSON. Thank you.

Next we will hear from Mr. Bobby Scott, from—oh yes, that is right. That is right. I am sorry. I will hear from Mr. Scott. [Laughter.]

Let us see. Do we have any other—anyone else that is interested in testifying?

Looks like we do not. Everybody has departed, so I would like to thank all the witnesses for their testimony today. Without objection, Members will have 5 legislative days to submit any additional written questions, which we will forward to the witnesses and ask that you answer as promptly as you can. They will be made part of the record. Without objection, the record will remain open for 5 legislative days for the submission of any other additional material.

Mr. WATT. Mr. Chairman?

Mr. JOHNSON. Yes.

Mr. WATT. Could I ask the Chair to buttress my request for written responses to the questions that we ask on the record? I am not sure I have the authority to do that. It may require the Chair's intervention on my behalf.

Mr. JOHNSON. Well, thank you, Congressman Watt. Of course, just because you have seniority doesn't mean that I have got to do what you say, but you are on——

Mr. WATT. That is why I made the request, Mr. Chairman. It wasn't a directive; it was a request.

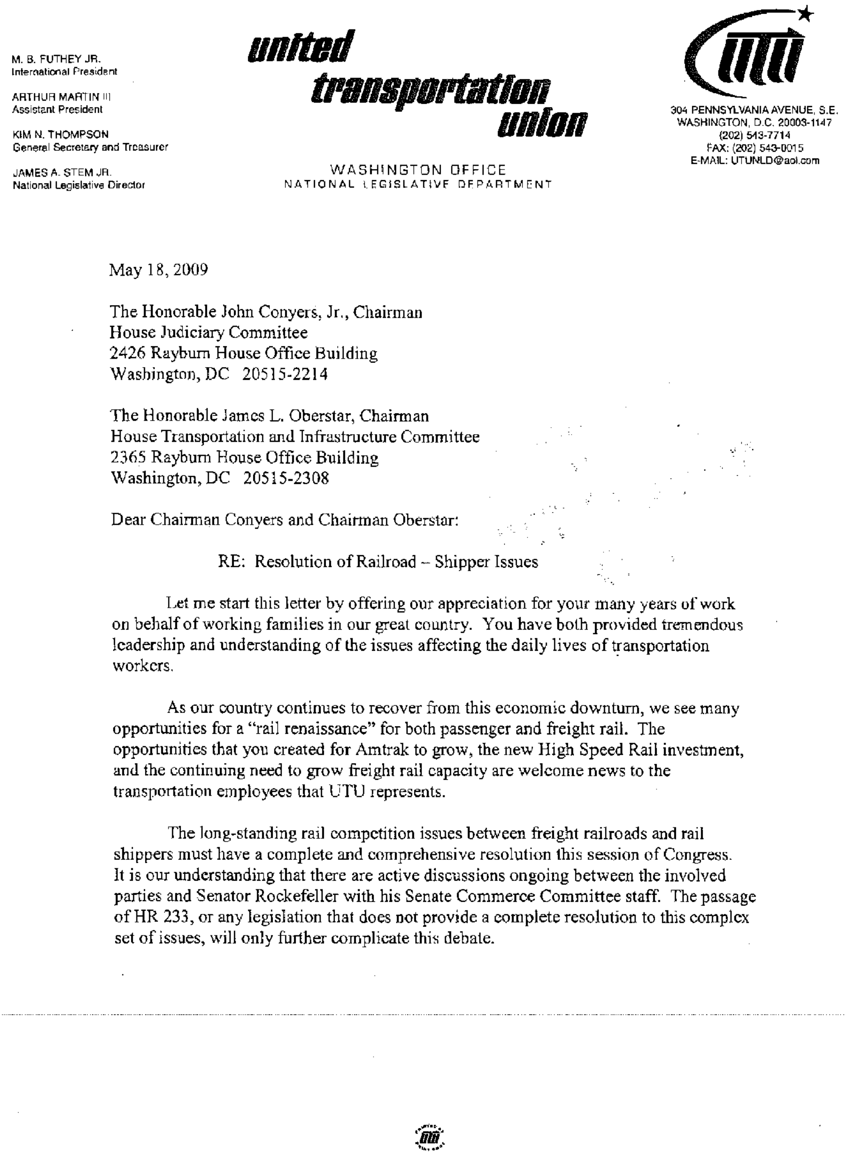
Mr. JOHNSON. All right. Any objection?

All right. Thank you. Thank you, and this Subcommittee meeting is adjourned.

[Whereupon, at 4:15 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record



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May 18, 2009

The Honorable John Conyers, Jr., Chairman
House Judiciary Committee
2426 Rayburn House Office Building
Washington, DC 20515-2214

The Honorable James L. Oberstar, Chairman
House Transportation and Infrastructure Committee
2365 Rayburn House Office Building
Washington, DC 20515-2308

Dear Chairman Conyers and Chairman Oberstar:

RE: Resolution of Railroad – Shipper Issues

Let me start this letter by offering our appreciation for your many years of work on behalf of working families in our great country. You have both provided tremendous leadership and understanding of the issues affecting the daily lives of transportation workers.

As our country continues to recover from this economic downturn, we see many opportunities for a "rail renaissance" for both passenger and freight rail. The opportunities that you created for Amtrak to grow, the new High Speed Rail investment, and the continuing need to grow freight rail capacity are welcome news to the transportation employees that UTU represents.

The long-standing rail competition issues between freight railroads and rail shippers must have a complete and comprehensive resolution this session of Congress. It is our understanding that there are active discussions ongoing between the involved parties and Senator Rockefeller with his Senate Commerce Committee staff. The passage of HR 233, or any legislation that does not provide a complete resolution to this complex set of issues, will only further complicate this debate.

I am writing to ask for a short delay in consideration of HR 233, pending a more comprehensive piece of legislation that is now being developed. It is certainly in the best interest of railroads, shippers, and railroad employees to resolve this issue once and for all with a comprehensive solution that addresses all aspects of this problem.

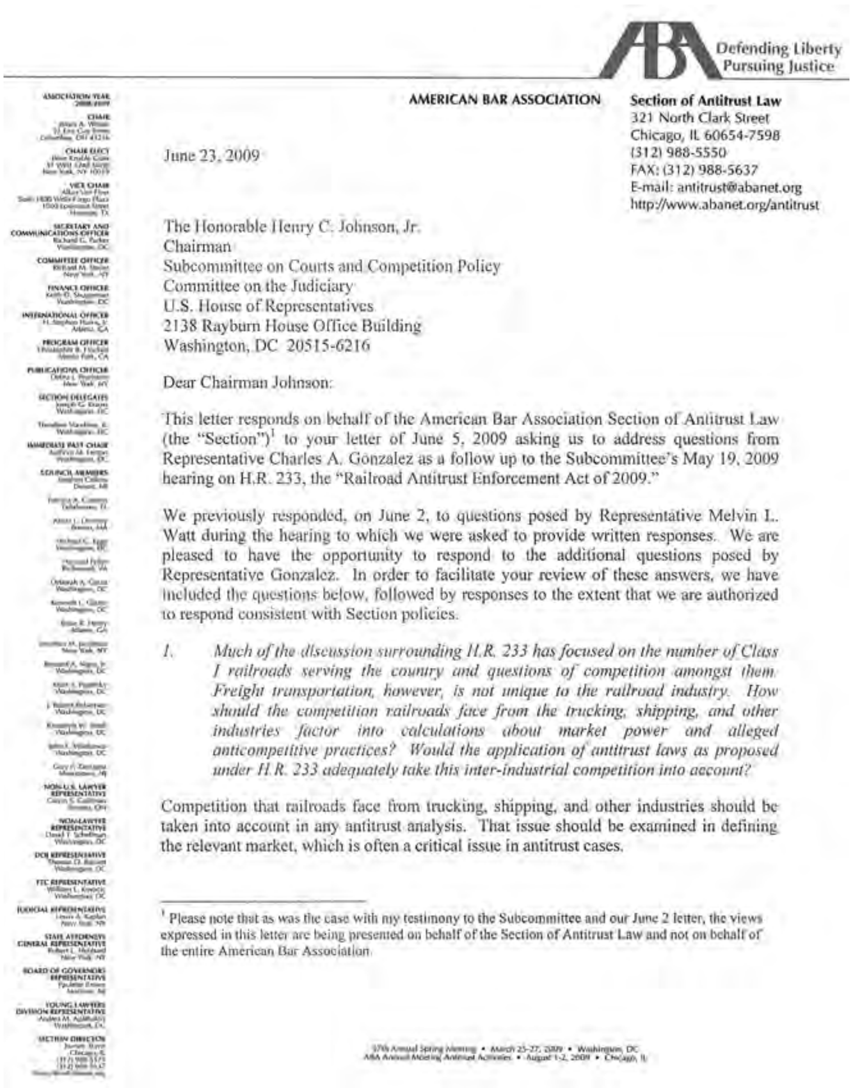
We sincerely appreciate your active participation in helping the railroad community move beyond this debate by allowing a prompt, comprehensive resolution of these issues.

Sincerely yours,

M.B. Futhey, Jr.

Malcolm B. Futhey, Jr.
International President

Cc: The Honorable Nancy Pelosi, Speaker of the House
The Honorable Jay Rockefeller, Chairman, Senate Commerce and Transportation Committee
The Honorable Lamar Smith, Ranking Member, House Judiciary Committee
The Honorable John Mica, Ranking Member, House Transportation and Infrastructure Committee
The Honorable Henry C. Johnson, Jr., Chairman House Subcommittee on Courts and Competition
The Honorable Howard Coble, Ranking Member, House Subcommittee on Courts and Competition
The Honorable Corrine Brown, Chairwoman, House Subcommittee on Railroads, Pipelines, and Hazardous Materials
The Honorable Bill Shuster, Ranking Member, House Subcommittee on Railroads, Pipelines, and Hazardous Materials
Ed Rodzwicz, President, Brotherhood of Locomotive Engineers and Trainmen
James Stem, UTU National Legislative Director
UTU Board of Directors



Defending Liberty
Pursuing Justice

AMERICAN BAR ASSOCIATION

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June 23, 2009

The Honorable Henry C. Johnson, Jr.
Chairman
Subcommittee on Courts and Competition Policy
Committee on the Judiciary
U.S. House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515-6216

Dear Chairman Johnson:

This letter responds on behalf of the American Bar Association Section of Antitrust Law (the "Section")[1] to your letter of June 5, 2009 asking us to address questions from Representative Charles A. Gonzalez as a follow up to the Subcommittee's May 19, 2009 hearing on H.R. 233, the "Railroad Antitrust Enforcement Act of 2009."

We previously responded, on June 2, to questions posed by Representative Melvin L. Watt during the hearing to which we were asked to provide written responses. We are pleased to have the opportunity to respond to the additional questions posed by Representative Gonzalez. In order to facilitate your review of these answers, we have included the questions below, followed by responses to the extent that we are authorized to respond consistent with Section policies.

1. *Much of the discussion surrounding H.R. 233 has focused on the number of Class I railroads serving the country and questions of competition amongst them. Freight transportation, however, is not unique to the railroad industry. How should the competition railroads face from the trucking, shipping, and other industries factor into calculations about market power and alleged anticompetitive practices? Would the application of antitrust laws as proposed under H.R. 233 adequately take this inter-industrial competition into account?*

Competition that railroads face from trucking, shipping, and other industries should be taken into account in any antitrust analysis. That issue should be examined in defining the relevant market, which is often a critical issue in antitrust cases.

---

[1] Please note that as was the case with my testimony to the Subcommittee and our June 2 letter, the views expressed in this letter are being presented on behalf of the Section of Antitrust Law and not on behalf of the entire American Bar Association.

The Supreme Court explained in *Brown Shoe v. United States*,

> [t]he outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross elasticity of demand between the product itself and substitutes for it.

370 U.S. 294, 325 (1962). The Court, in *United States v. E.I. DuPont de Nemours & Co.*, explained,

> where a product is controlled by one interest, without substitutes available in the market, there is monopoly power.... [W]here there are market alternatives that buyers may readily use for their purposes, illegal monopoly does not exist merely because the product said to be monopolized differs from others.

351 U.S. 377, 394 (1956). In considering reasonable interchangeability, the courts will consider a variety of evidence, including industry and public perception, customer views of interchangeability, and the relationship between prices and sales, in addition to differences in prices and physical characteristics of products and services.

Discussing geographic market issues, which are "essentially similar," the Court in *Brown Shoe* explained that "Congress prescribed a pragmatic, factual approach to the definition of the relevant market and not a formal legalistic one." The market must, therefore, both "correspond to the commercial realities" of the industry and "be economically significant." 370 U.S. 294, 336-37 (1962).

Under the Government's Merger Guidelines, the Department of Justice and Federal Trade Commission define a relevant market by considering whether a hypothetical monopolist "likely would impose ... a small but significant and non-transitory" price increase, generally a price increase of five percent lasting for the foreseeable future. In considering the likely reaction of buyers to a price increase, the government takes into account evidence such as whether buyers have shifted or considered shifting in response to relative changes in price or other competitive variables, whether sellers base business decisions on the prospect of buyer substitution, and the timing and cost of switching.

The market definition in any particular antitrust case involving railroads will turn on the specific facts, considering the origin, destination and commodities at issue, and the alternatives available to customers. To the extent that railroads face competition from trucking, shipping and other industries, that competition should factor into the relevant market definition. H.R. 233 would subject the railroad industry to the nation's antitrust laws, but it would not alter fundamental antitrust analysis as applied to railroads. As such, inter-industrial competition with railroads should be taken into account.

a. *The report Mr. Cooper submitted for the record makes much of the fact that STB uses a pricing standard based on the "cost for the shipper to build a stand-alone railroad". What barriers prevent shippers from doing just that? Or other companies from building short-lines that would connect captive shippers to an interchange point where competition might begin?*

The Section of Antitrust Law does not have the expertise to identify specific barriers to shippers or other railroads building stand-alone or short-line railroads. Such barriers, which likely vary on different routes, may include the availability of land, environmental permitting, licensing requirements, sunk capital costs, and a large minimum scale of operations for efficient production, which individually or collectively may make entry expensive, difficult and time consuming.

The Section has not adopted a position regarding the appropriate pricing standard that the STB should use in determining whether a railroad's rates should be regulated. We note, however, that setting prices for a contract by regulation based on the "cost of the shipper to build a stand-alone railroad" may allow the exercise of market power if the asset may last longer than the length of the contract or if the asset is used to serve multiple shippers, and the Section believes generally that consumers are best served when rates are set through competitive forces protected by the antitrust laws rather than regulation.

b. *Mr. Hemmer mentioned several times the fact that H.R. 233 makes changes to regulatory and antitrust policy just for railroads. If the same policies were applied universally, would they be less objectionable to Union Pacific? If they are just and appropriate changes, is it not appropriate to enforce them, even if only on the one industry?*

The Section testimony specifically "encourage[d] Congress to move forward quickly to dismantle the antitrust exemption for the railroad industry, through the Railroad Antitrust Enforcement Act, and to consider additional legislation to eliminate antitrust exemptions applicable to the industries." The Section endorses the Antitrust Modernization Commission recommendation that antitrust exemptions should be granted "only where, and for so long as … is necessary to satisfy a specific societal goal that trumps the benefit of a free market to consumers and the U.S. economy in general." The Section supports the elimination of exemptions that can no longer be justified, and the proposed legislation is an appropriate step in that direction.

2. *We have discussed situations in which a shipper is captive to one railroad that controls, e.g., the sole rail line that runs to its plant. Are there now or have there been cases in which a shipper is captive to two railroads, e.g., if a single carrier serves the mine and another sole carrier serves the factory? If so, how were those*

> *transactions accomplished? If not, is this a plausible situation and how might the question of rates be resolved, whether under current standards or if H.R. 233 should be passed.*

The Section of Antitrust Law does not have the expertise to address whether the case described in the question exists in the railroad industry. In most circumstances, however, we suspect that where a producer or a customer is captive to a railroad, that such producer may have alternative customers (that are not captive to a railroad) and such customers may have alternative suppliers (that are not captive).

In general, economics teaches that two consecutive monopolists will together charge a price that is higher than a single monopolist because of the problem of "double marginalization." It may therefore be efficient to allow monopolists to merge or form a venture to charge a single monopoly price. On the other hand, a single monopoly may prevent competition from developing over time because a prospective competitor would have to enter into both markets rather than only one market. Allowing interconnections with monopoly local service providers and encouraging competition over long distance, at least in the telecommunications industry, has led to lower rates and enhanced services for consumers. We have also seen markets once perceived to be natural monopolies, such as local telephone and cable television service, face competition in recent years.

Since the 1980 Staggers Rail Act, the Interstate Commerce Commission and Surface Transportation Board have had authority to regulate rates only for traffic where insufficient competition exists to protect shippers. As explained in our testimony, allowing an antitrust exemption is particularly troubling where an industry is being deregulated, and there is uncertainty as to whether activity is exempted from regulation.

* * * *

We again thank the Subcommittee for the opportunity to present our views. If you have any additional questions, or if we can be of any additional assistance to you and the Subcommittee, please ask your staff to contact me at (202) 842-8883

Respectfully yours,

M. Howard Morse

M. Howard Morse

cc: Christal Sheppard, Chief Counsel, Subcommittee on Court and Competition Policy
Anant Raut, Counsel, Subcommittee on Courts and Competition Policy
R. Larson Frisby, Senior Legislative Counsel, ABA Governmental Affairs Office

(2-9)

LAFAYETTE CONSOLIDATED GOVERNMENT

LAFAYETTE UTILITIES SYSTEM

LUS
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June 25, 2009

VIA HAND DELIVERY

The Honorable Henry C. Johnson, Jr.
Chairman
Subcommittee on Courts and Competition Policy
of the House Judiciary Committee
B-352 Rayburn House Office Building
Washington, DC 20515

Re: May 19, 2009 Hearing on H.R. 233, "Railroad Antitrust Enforcement Act of 2009" Before the Subcommittee on Courts and Competition of the House Judiciary Committee

Dear Chairman Johnson:

In response to your letter of June 5, 2009, and for inclusion in the hearing record, Lafayette Utilities System ("LUS") respectfully submits the attached written responses to the follow-up questions submitted by Representative Charles A. Gonzalez.

LUS appreciates this opportunity to further respond to questions and issues raised at the Hearing.

Sincerely yours,

Terry Huval

Terry Huval, P.E.
Director, Lafayette Utilities System
(337) 291-5804
Lafayette (LA) Consolidated Government

cc: Honorable Charles A. Gonzalez

Responses of

Terry Huval, Director of Utilities
Lafayette Utilities System
Lafayette (LA) Consolidated Government

Before the
House Judiciary Committee
Subcommittee on Courts and Competition

Hearing on H.R. 233,
the "Railroad Antitrust Enforcement Act of 2009"

Responses to questions submitted by Representative Charles A. Gonzalez

1. Much of the discussion surrounding H.R. 233 has focused on the number of Class I railroads serving the country and questions of competition amongst them. Freight transportation, however, is not unique to the railroad industry. How should the competition railroads face from the trucking, shipping, and other industries factor into calculations about market power and alleged anticompetitive practices? Would the application of antitrust laws as proposed under H.R. 233 adequately take this inter-industrial competition into account?

Response:

Railroads sometimes claim that individual customers may have effective inter- or intra-modal competitive substitutes (e.g., the ability to choose among rail, truck, and water modes of transportation) that prevent a rail carrier from unreasonably raising rates for service. However, for many bulk commodities, such as coal, there is no effective competition available. The Lafayette Utilities System ("LUS") is dependant on the Rodemacher coal-fired electric generating station to provide the majority of the electric energy used in the City of Lafayette, a community of 120,000. The only practical way to transport coal fuel from the originating Wyoming mines to Rodemacher (a distance of over

1,500 miles) is by rail. LUS faces monopoly pricing as it is "captive" to one carrier at destination and it is unable to obtain effective inter- or intra-modal competition.

For Lafayette, Louisiana, we believe this lack of railroad competition has translated into over $65 million in "captivity payments" during the last ten years – the difference between what LUS has paid its existing rail carrier between 1999 and 2008 compared to what LUS estimates it would have paid if it had access to effective railroad competition. These higher payments are included in LUS customers' monthly electric bills and cause higher utility bills for all individuals and businesses in Lafayette.

LUS needs meaningful pro-competitive remedies to protect its electricity consumers from this undue cost of captivity. Today, the railroads are exempt from many antitrust laws and the Surface Transportation Board (STB) has already said it is fine for the UP to block LUS' access to competition through its ruling in the Bottleneck Decision. LUS urges Congress to enact laws that encourage and require railroads to compete effectively and that accord rail shippers full legal recourse if railroads act in violation of the competition laws. For this reason, LUS supports H.R. 233.

Finally, even for markets that currently enjoy effective inter- or intra-modal competition options (e.g., truck competition for containers moving over short distances) there still is the need for the antitrust laws to apply in the same way that these laws apply to the vast majority of businesses in the United

States. If railroad carriers are fairly and effectively competing in the marketplace, then there should be no anticompetitive concerns, because the railroads should be in full compliance with the competition laws. It is only when competitors engage in practices that are contrary to the competition laws (e.g., collective arrangements used as a means to accomplish market division or price stabilization and avoid competition, etc.) that those practices are open to antitrust challenge – including in those markets where effective competition may once have existed.

a. The report Mr. Cooper submitted for the record makes much of the fact that STB uses a pricing standard based on the "cost for the shipper to build a stand-alone railroad". What barriers prevent shippers from doing just that? Or other companies from building short-lines that would connect captive shippers to an interchange point where competition might begin?

Response:

LUS respectfully submits that the large-scale construction of redundant rail lines in communities across the Nation is not a feasible or sound means of addressing the competitive problems facing railroad customers. Also, for individual shippers, pursuing such a "build-out" option to obtain competitive rail access is a costly undertaking, and potentially creates significant environmental, community, and other related socio-economic impacts. For example, a build-out option for Lafayette would require us to building a large-scale bridge, which would have to cross over both the Red River and the immediately adjacent Interstate 49 highway in order to enable Lafayette to access other railway services. The cost of constructing such a bridge is enormous, and far in excess of the burden our consumers can be expected to bear. The City of Lafayette is not interested in building its own, redundant railroad.

Even if the construction of such new railroad lines in some instances were feasible, LUS respectfully submits that effectively compelling captive shippers to build their own railroads to duplicate existing facilities is not a prudent policy choice or in the public interest, especially when the cause of such action is the simple refusal of the rail companies to operate their lines in a pro-competitive fashion.

As explained in detail in my testimony, LUS believes that it is not unreasonable to suggest that the existing carriers that each have routes extending more than 99% of the length of the movement from the coal mine origin to LUS' destination should actively and aggressively compete for this portion of the haul where there already exists the potential for competition to work. To the contrary, it is unreasonable for these existing carriers to suggest that they need to be protected from aggressively engaging in marketplace competition like any other business. The fact that railroad carriers today are not actively seeking to compete for this business demonstrates that the competitive market is not efficiently working and that this needs to be addressed with the passage of H.R. 233 – and not through the construction of a multitude of redundant rail line build-outs.

b. Mr. Hemmer mentioned several times the fact that H.R. 233 makes changes to regulatory and antitrust policy just for railroads. If the same policies were applied universally, would they be less objectionable to Union Pacific? If they are just and appropriate changes, is it not appropriate to enforce them, even if only on the one industry?

Response:

LUS agrees that it is appropriate to apply just and appropriate policy changes, even if those changes are applied to only one or a few industries, and not all industries. However, LUS respectfully submits that the railroads are not being "singled out" with H.R. 233. In fact, the railroads are one of the few remaining industries that enjoy immunities and exemptions from the antitrust laws. The bipartisan Antitrust Modernization Commission ("AMC") agrees that the application of the competition laws to our Nation's businesses is the norm:

> All kinds of businesses across the United States . . . comply with the antitrust laws as they plan their activities, including joint activities with competitors. This is not hypothetical economic theory; it is how hundreds of thousands of firms do business every day. Because they must comply with the antitrust laws, these firms structure their activities to avoid anti-competitive effects. This promotes consumer welfare.

Antitrust Modernization Commission, Report and Recommendations to Congress (Apr. 2007) at 358 ("AMC Final Report") (internal footnotes omitted). The AMC recommended in its final report to Congress that the clear burden be placed on the exempt industry to justify the continuation of any antitrust immunity[1] and concluded that "it heard no compelling justification for any of the exemptions on which it held hearings."[2] It is the railroads that are enjoying disparate favorable treatment with their antitrust immunities, and there is no legitimate justification for maintaining these immunities.

2. We have discussed situations in which a shipper is captive to one railroad that controls, e.g., the sole rail line that runs to its plant. Are there now or have there been cases in which a shipper is captive to two railroad, e.g., if a single carrier serves the mine and another sole carrier serves the factory? If so, how were those transactions accomplished? If not, is this a plausible situation and how might the question of rates be resolved, whether under current standards or if H.R. 233 should be passed.

Response:

Currently, there are many instances where two (or sometimes more) rail carriers are required to move products between origin and destination points. For example, there is no single transcontinental railroad system in the United States, so movements that cross the Country from east-to-west often involve the interchange of traffic between two carriers. Carriers also have trackage rights arrangements with one another over portions of their systems, which likewise require coordination. Coordination between railroad and trucking firms is also required with inter-modal (i.e., container or trailer) movements.

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[1] See, e.g., AMC Final Report at 350 (Recommendation No. 57). ("Statutory immunities from the antitrust laws should be disfavored. They should be granted rarely, and only where, and for so long as, a clear case has been made that the conduct in question would subject the actors to antitrust liability *and* is necessary to satisfy a specific societal goal that trumps the benefit of a free market to consumers and the U.S. economy in general.")

[2] Id. at 353.

Under current law, the rates and service terms being offered for service to prospective customers are decided by the carriers involved in the requested service. The operational logistics (e.g., use of crews and locomotive power) are also decided by the involved carriers. This situation would not change under H.R. 233. Carriers could continue to collaborate on rates and service to the extent that such collaboration did not involve a violation of the competition laws. If the carriers engaged in anticompetitive practices in rate setting or service, they would be subject to scrutiny under the antitrust laws.

The antitrust law experts fully agree that even in industries where firms engage in extensive service coordination activities, such as in the ocean carrier industry, these firms should not enjoy antitrust immunity, and the antitrust laws should apply in full force:

> Although Congress substantially modified the Shipping Act in 1998 to allow individually negotiated rates, which has sharply reduced ocean carriers' use of jointly set "conference rates," proponents assert that an antitrust exemption remains necessary for other purposes. They maintain that carriers need an antitrust exemption to adopt more efficient practices jointly, such as agreements that allow ocean carriers to share certain equipment at ports in order to reduce congestion. Acknowledging the possibility that such agreements could withstand antitrust scrutiny, one witness maintained that the ocean carriers nevertheless would not attempt them absent the certainty that no antitrust liability would result. The witness emphasized the enormous investments of ocean carriers and the need to eliminate even the potential for antitrust liability.
>
> However, this reasoning reduces to an argument that ocean carriers should not be subject to the same

> costs of doing business as other industries. These costs of doing business include managing firms' conduct to comply with antitrust, and many other, laws. All kinds of businesses across the United States -- including firms that make investments comparable to or greater than those of ocean carriers – comply with the antitrust laws as they plan their activities, including joint activities with competitors. . . . There does not appear to be anything unique about ocean carriers that would merit holding them to a lesser standard.[3]

The application of the antitrust laws to the railroad industry will not prevent individual companies from engaging in reasonable joint activities with competitors as necessary to efficiently move commerce. Only if competitors coordinate in an anticompetitive manner would they be subject to antitrust scrutiny.

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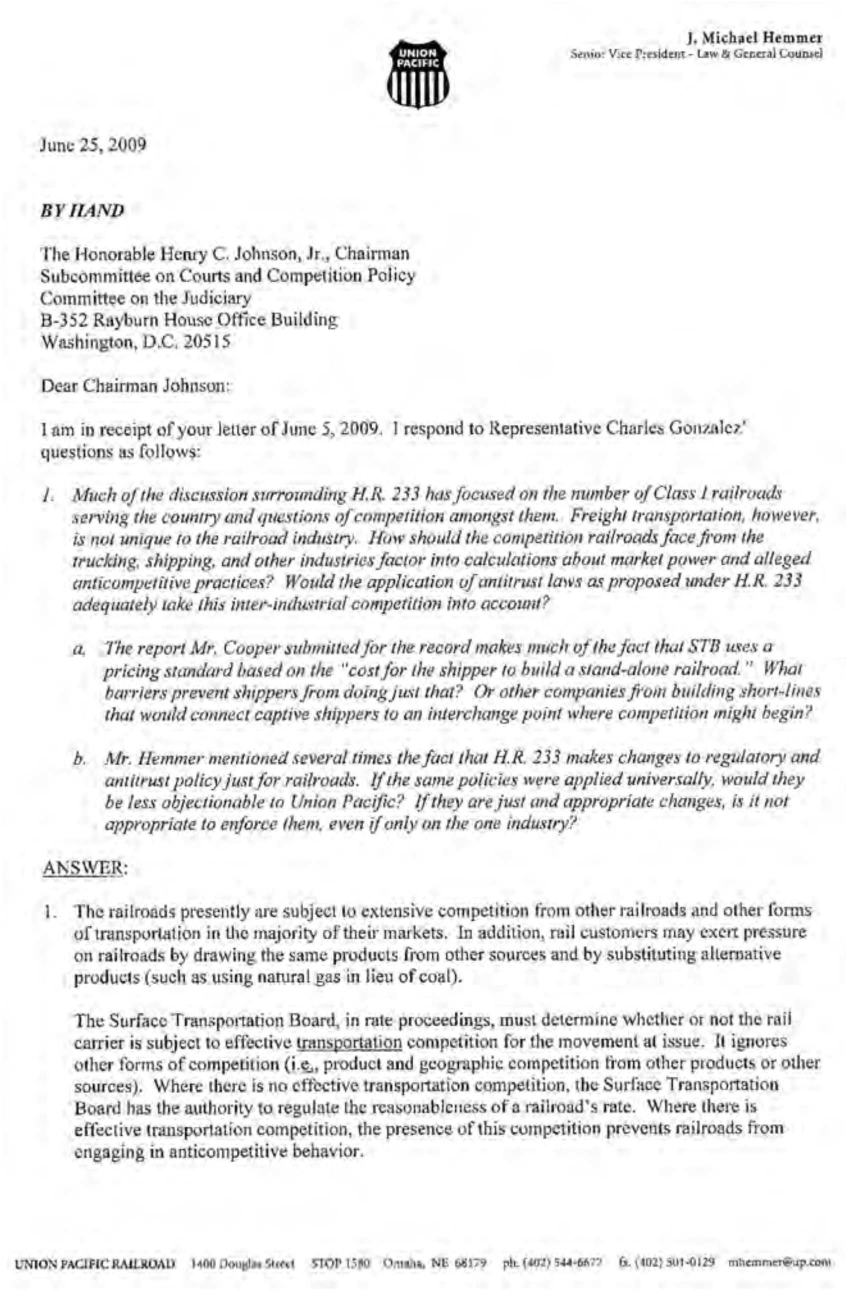
[3] Id. at 351-52 (internal footnotes omitted).



J. Michael Hemmer
Senior Vice President - Law & General Counsel

June 25, 2009

BY HAND

The Honorable Henry C. Johnson, Jr., Chairman
Subcommittee on Courts and Competition Policy
Committee on the Judiciary
B-352 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Johnson:

I am in receipt of your letter of June 5, 2009. I respond to Representative Charles Gonzalez' questions as follows:

1. *Much of the discussion surrounding H.R. 233 has focused on the number of Class I railroads serving the country and questions of competition amongst them. Freight transportation, however, is not unique to the railroad industry. How should the competition railroads face from the trucking, shipping, and other industries factor into calculations about market power and alleged anticompetitive practices? Would the application of antitrust laws as proposed under H.R. 233 adequately take this inter-industrial competition into account?*
    a. *The report Mr. Cooper submitted for the record makes much of the fact that STB uses a pricing standard based on the "cost for the shipper to build a stand-alone railroad." What barriers prevent shippers from doing just that? Or other companies from building short-lines that would connect captive shippers to an interchange point where competition might begin?*
    b. *Mr. Hemmer mentioned several times the fact that H.R. 233 makes changes to regulatory and antitrust policy just for railroads. If the same policies were applied universally, would they be less objectionable to Union Pacific? If they are just and appropriate changes, is it not appropriate to enforce them, even if only on the one industry?*

ANSWER:

1. The railroads presently are subject to extensive competition from other railroads and other forms of transportation in the majority of their markets. In addition, rail customers may exert pressure on railroads by drawing the same products from other sources and by substituting alternative products (such as using natural gas in lieu of coal).

   The Surface Transportation Board, in rate proceedings, must determine whether or not the rail carrier is subject to effective transportation competition for the movement at issue. It ignores other forms of competition (i.e., product and geographic competition from other products or other sources). Where there is no effective transportation competition, the Surface Transportation Board has the authority to regulate the reasonableness of a railroad's rate. Where there is effective transportation competition, the presence of this competition prevents railroads from engaging in anticompetitive behavior.

Antitrust courts, under some antitrust theories, would not consider the presence of competition in antitrust litigation. More commonly, however, they do consider its effects. Under H.R. 233, those courts would be discouraged from seeking input from the regulatory agency with expertise in determining the existence and effects of transportation competition.

a. Competing railroads sometimes "build-in" to a shipper, and shippers "build-out" to a competing railroad. The use of a "build-in" or a "build-out" is a powerful competitive option, and it reflects the marketplace at work. It is not artificial rail competition introduced by regulatory fiat.

   The concept is straightforward. If the marketplace will support two railroads, a second railroad will enter that market. For instance, UP's competitor, BNSF, built into a chemical plant in North Sea Drift, Texas. Of course, a shipper can also build out to a competing railroad, as Nebraska Public Power District did at what it calls the Gentleman Station, when it built out to connect to the Union Pacific. Railroads also use what are called "transload facilities" where traffic is trucked to and from the railroad to introduce new competition. An example of this is outside of Oklahoma City, where UP established a transload facility to serve a General Motors plant that had been solely served by BNSF.

   In addition, actually building in or out to a facility is not necessary to introduce competitive responses by the railroads. Often customers use the threat of new construction during a contract negotiation to extract a better rate or other conditions from the serving railroad.

   With respect to the expense of a build-in or build-out, that expense reflects the true cost of building and maintaining a railroad and will be pursued where the investment is justified, just as the stand-alone cost test is intended to set the appropriate level of a regulated rail rate at the market level. Using regulation (or the courts) to force access interferes with the marketplace at work. Artificial government regulation will ultimately lead to less revenue for the rail industry and a smaller rail network.

b. The Antitrust Modernization Commission expressed general opposition to antitrust exemptions that favor one industry. Accordingly, if antitrust exemptions are to be removed from one industry, they should be removed from all, or new favoritism will be created. It is ironic that the electrical utility industry is one of the strongest promoters of H.R. 233, yet that industry, and not the railroads, relies on the Keogh Doctrine to protect it from the antitrust laws. H.R. 233's repeal of the Keogh Doctrine for railroads would have essentially no effect, because it would not remove the doctrine from the utility industry that uses the doctrine as a shield.

   H.R. 233's limitation on the doctrine of primary jurisdiction is not a "just and appropriate change" for railroads or any other industry, and it should be stricken from the bill. This doctrine, a century in the making, creates consistency between courts and regulatory agencies. Destroying that coordination would guarantee conflicts between courts and agencies and would be irrational public policy. In fact, the Antitrust Section of the American Bar Association in its June 2, 2009 letter to you on H.R. 233 encouraged the referral of matters to the regulatory agency under the doctrine of primary jurisdiction in appropriate circumstances.

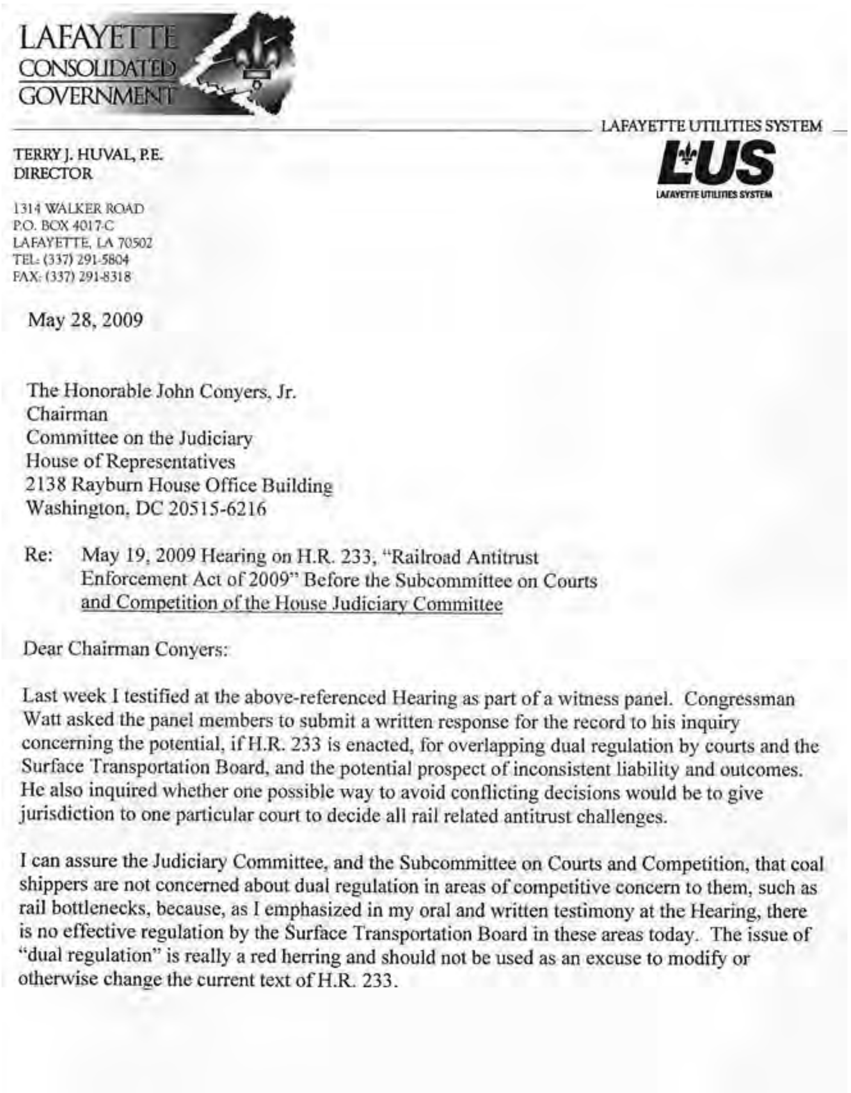
2. *We have discussed situations in which a shipper is captive to one railroad that controls, e.g., the sole rail line that runs to its plant. Are there now or have there been cases in which a shipper is captive to two railroad, e.g., if a single carrier serves the mine and another sole carrier serves the factory? If so, how were those transactions accomplished? If not, is this a plausible situation and how might the question of rates by resolved, whether under current standards or if H.R. 233 should be passed.*

ANSWER:

2. There are many instances where one railroad serves an origin shipper and another railroad serves a destination location. In fact, this is commonplace in the rail industry. In those situations, the origin railroad is required to interchange the traffic with the connecting railroad that provides service to the destination in order to complete the shipment. Rates in these situations are subject to STB regulation, to the same extent as other rates in the rail industry.

Sincerely, Mike Hemmer

J. Michael Hemmer



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May 28, 2009

The Honorable John Conyers, Jr.
Chairman
Committee on the Judiciary
House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515-6216

Re: May 19, 2009 Hearing on H.R. 233, "Railroad Antitrust Enforcement Act of 2009" Before the Subcommittee on Courts and Competition of the House Judiciary Committee

Dear Chairman Conyers:

Last week I testified at the above-referenced Hearing as part of a witness panel. Congressman Watt asked the panel members to submit a written response for the record to his inquiry concerning the potential, if H.R. 233 is enacted, for overlapping dual regulation by courts and the Surface Transportation Board, and the potential prospect of inconsistent liability and outcomes. He also inquired whether one possible way to avoid conflicting decisions would be to give jurisdiction to one particular court to decide all rail related antitrust challenges.

I can assure the Judiciary Committee, and the Subcommittee on Courts and Competition, that coal shippers are not concerned about dual regulation in areas of competitive concern to them, such as rail bottlenecks, because, as I emphasized in my oral and written testimony at the Hearing, there is no effective regulation by the Surface Transportation Board in these areas today. The issue of "dual regulation" is really a red herring and should not be used as an excuse to modify or otherwise change the current text of H.R. 233.

Even if dual regulation was a real, practical concern (which it is not), all administrative litigations in recent years at the Surface Transportation Board involving competition issues (other than rail mergers) have involved individual complaints filed by rail shippers. To the extent H.R. 233 would permit shippers to pursue such relief at either the Surface Transportation Board or in courts, there are established legal doctrines, including the law of election of remedies that would foreclose a shipper from being able to pursue the same pro-competitive relief in both forums.

Moreover, in the unlikely event that multiple shippers presented similar competitive claims in different courts, or in courts as well as proceedings before the Surface Transportation Board, there are other established legal practices and principles in place to address and avoid conflicting results. For example, similar claims raised by different shippers in different courts can be consolidated for consideration in a single court. Similarly, appropriate principles of concurrent jurisdiction could be employed to address situations where common claims are raised by some shippers in Surface Transportation Board proceedings and by other shippers in court proceedings.

Finally, I have been advised that in the Antitrust Modernization Commission's report to Congress, the Antitrust Modernization Commission has rejected as "particularly unpersuasive" arguments that antitrust immunities should be retained to protect industries against possible litigation risks, or to enhance regulatory compliance/investment return certainty:

> The Commission finds two arguments in favor of antitrust exemptions particularly unpersuasive, however. First, no immunity should be granted to create increased certainty in the form of freedom from antitrust compliance and litigation risk. Antitrust compliance and litigation risks are costs of doing business that hundreds of thousands of American businesses manage every day. No particular companies or industries should be specially entitled to avoid these costs; if these costs are unreasonable, broader reform applicable to all businesses is the proper remedy. Second no immunity should be granted to stabilize prices in order to provide an industry with certainty and predictability for purposes of investment or solvency. This too is a benefit that all industries would appreciate, but that none should be singled out to receive. The costs of price "stability" typically flow to consumers and result in inflexibility that undermines economic growth.[1]

---

[1] Antitrust Moderization Commission Report at 351 (internal citations omitted).

On behalf of Lafayette Utilities System, the American Public Power Association and Consumers United For Rail Equity, I urge the Congress to enact H.R. 233.

Sincerely yours,

Terry Huval

Terry Huval
Director of Utilities
Lafayette Utilities System
Lafayette (LA) Consolidated Government

cc: Honorable Henry C. Johnson
Honorable Melvin L. Watt

United States Government Accountability Office

GAO

Report to Congressional Requesters

October 2006

FREIGHT RAILROADS

Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed

GAO

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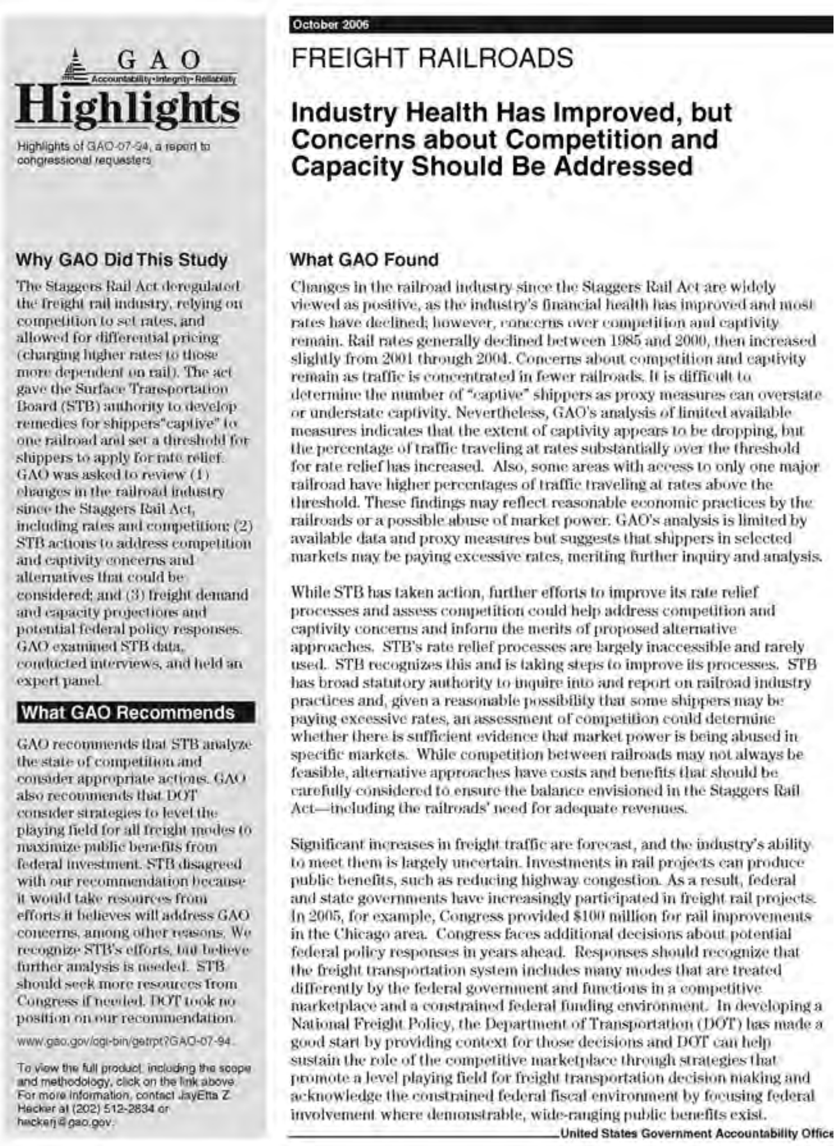

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Highlights

Highlights of GAO-07-94, a report to congressional requesters

Why GAO Did This Study

The Staggers Rail Act deregulated the freight rail industry, relying on competition to set rates, and allowed for differential pricing (charging higher rates to those more dependent on rail). The act gave the Surface Transportation Board (STB) authority to develop remedies for shippers"captive" to one railroad and set a threshold for shippers to apply for rate relief. GAO was asked to review (1) changes in the railroad industry since the Staggers Rail Act, including rates and competition; (2) STB actions to address competition and captivity concerns and alternatives that could be considered; and (3) freight demand and capacity projections and potential federal policy responses. GAO examined STB data, conducted interviews, and held an expert panel.

What GAO Recommends

GAO recommends that STB analyze the state of competition and consider appropriate actions. GAO also recommends that DOT consider strategies to level the playing field for all freight modes to maximize public benefits from federal investment. STB disagreed with our recommendation because it would take resources from efforts it believes will address GAO concerns, among other reasons. We recognize STB's efforts, but believe further analysis is needed. STB should seek more resources from Congress if needed. DOT took no position on our recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-07-94.

To view the full product, including the scope and methodology, click on the link above. For more information, contact JayEtta Z. Hecker at (202) 512-2834 or heckerj@gao.gov.

October 2006

FREIGHT RAILROADS

Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed

What GAO Found

Changes in the railroad industry since the Staggers Rail Act are widely viewed as positive, as the industry's financial health has improved and most rates have declined; however, concerns over competition and captivity remain. Rail rates generally declined between 1985 and 2000, then increased slightly from 2001 through 2004. Concerns about competition and captivity remain as traffic is concentrated in fewer railroads. It is difficult to determine the number of "captive" shippers as proxy measures can overstate or understate captivity. Nevertheless, GAO's analysis of limited available measures indicates that the extent of captivity appears to be dropping, but the percentage of traffic traveling at rates substantially over the threshold for rate relief has increased. Also, some areas with access to only one major railroad have higher percentages of traffic traveling at rates above the threshold. These findings may reflect reasonable economic practices by the railroads or a possible abuse of market power. GAO's analysis is limited by available data and proxy measures but suggests that shippers in selected markets may be paying excessive rates, meriting further inquiry and analysis.

While STB has taken action, further efforts to improve its rate relief processes and assess competition could help address competition and captivity concerns and inform the merits of proposed alternative approaches. STB's rate relief processes are largely inaccessible and rarely used. STB recognizes this and is taking steps to improve its processes. STB has broad statutory authority to inquire into and report on railroad industry practices and, given a reasonable possibility that some shippers may be paying excessive rates, an assessment of competition could determine whether there is sufficient evidence that market power is being abused in specific markets. While competition between railroads may not always be feasible, alternative approaches have costs and benefits that should be carefully considered to ensure the balance envisioned in the Staggers Rail Act—including the railroads' need for adequate revenues.

Significant increases in freight traffic are forecast, and the industry's ability to meet them is largely uncertain. Investments in rail projects can produce public benefits, such as reducing highway congestion. As a result, federal and state governments have increasingly participated in freight rail projects. In 2005, for example, Congress provided $100 million for rail improvements in the Chicago area. Congress faces additional decisions about potential federal policy responses in years ahead. Responses should recognize that the freight transportation system includes many modes that are treated differently by the federal government and functions in a competitive marketplace and a constrained federal funding environment. In developing a National Freight Policy, the Department of Transportation (DOT) has made a good start by providing context for those decisions and DOT can help sustain the role of the competitive marketplace through strategies that promote a level playing field for freight transportation decision making and acknowledge the constrained federal fiscal environment by focusing federal involvement where demonstrable, wide-ranging public benefits exist.

United States Government Accountability Office

Contents

Letter 1

Results in Brief 3
Background 6
Railroad Industry Increasingly Healthy and Rates Generally Down Since Enactment of the Staggers Rail Act, but Concerns about Competition and Captivity Remain 9
Despite STB's Actions, Analysis of Competitive Markets Is Needed to Address Lack of Effective Relief for Captive Shippers 38
Uncertainty about Future Freight Rail Demand and Capacity Points to Opportunities for a More Strategic Federal Approach to Rail Infrastructure 53
Conclusions 64
Recommendations for Executive Action 66
Agency Comments and Our Evaluation 67

Appendix I **Participants in GAO's Expert Panel** 72

Appendix II **Objectives, Scope, and Methodology** 74

Appendix III **Comments from the Surface Transportation Board** 77
GAO Comments 83

Appendix IV **GAO Contact and Staff Acknowledgments** 87

Related GAO Products 88

Tables

Table 1: Changes in Percentage of Industry Revenue and Tonnage on Origin and Destination Routes with Access to One Class I Railroad 28
Table 2: Possible Changes in R/VC Ratios 30
Table 3: Potential Public Benefits of Rail Transportation Investments 58

Figures

Figure 1: Railroads' Tax-Adjusted Return on Investment, 1980-2004 10
Figure 2: Trends in Industry Rail Rates, 1985-2004 12
Figure 3: Commodity Rate Changes, 1985-1989, 1990-1999, and 2000-2004 13
Figure 4: Rate Changes for Coal, Grain, Miscellaneous Mixed Shipments, and Motor Vehicles, 1985-2004 14
Figure 5: Rail Rate Increases and Decreases across 604 Routes, and for Long-, Medium-, and Short-distance Routes, 2000 through 2004 15
Figure 6: Tonnage Carried by Railcar Ownership, 1987-2004 17
Figure 7: Miscellaneous Revenue Tracked in Carload Waybill Sample, 2000-2004 18
Figure 8: Percentage of Railroad Market Represented by Four Largest Class I Railroads, 1985-2004 20
Figure 9: Comparison of Rates Charged on Long-distance Grain Routes, 1997-2004 22
Figure 10: Rate Changes after the Introduction of a Second Carrier 23
Figure 11: Comparison of Rate Changes from Champaign, Illinois, Economic Area to New Orleans, Louisiana, Economic Area and Champaign, Illinois, Economic Area to Atlanta, Georgia, Economic Area, 1990-2004 24
Figure 12: Number of Class I Railroads Serving Economic Areas, 2004 26
Figure 13: Percentage of All Industry Tonnage Originating in Economic with Access to One Class I Railroad, 2004 27
Figure 14: Changes in Percentage of All Industry Traffic Tonnage with Access to One Class I Railroad Originating in Economic Areas, 1994 through 2004 29
Figure 15: Percentage of Industry Tonnage and Revenue Generated from Traffic Traveling at Rates Equal to or Greater Than 180 Percent R/VC, 1985-2004 31
Figure 16: Tonnage Traveling at Rates over 300 Percent R/VC, 1985-2004 32
Figure 17: Percentage of Tonnage by R/VC, 1985 and 2004 33
Figure 18: Changes in Percentage of Tonnage Traveling at Rates over 300 Percent R/VC, by Originating Economic Area, 1985 through 2004 34
Figure 19: Long-distance Grain Route Changes in Percentage of Tonnage Traveling at Rates over 300 Percent R/VC, 1985-2004 35

Figure 20: Overlap between Percentage of Tonnage over Threshold for Rate Relief and Access to Only One Class I Railroad 37
Figure 21: Reciprocal Switching 45
Figure 22: Terminal Agreements 47
Figure 23: Trackage Rights 48
Figure 24: Bottleneck Rates 50
Figure 25: Paper Barriers 51

Abbreviations

AASHTO	American Association of State Highway and Transportation Officials
ATA	American Trucking Association
BEA	Bureau of Economic Analysis
CBO	Congressional Budget Office
CDOT	Colorado Department of Transportation
CREATE	Chicago Region Environmental and Transportation Efficiency program
DOT	Department of Transportation
FAF	Freight Analysis Framework
FHWA	Federal Highway Administration
FOA	Final Offer Arbitration
GDP	gross domestic product
ICC	Interstate Commerce Commission
RRIF	Railroad Rehabilitation and Improvement Financing
R/VC	revenue to variable cost
RRIF	Railroad Rehabilitation and Improvement Financing program
SAFETEA-LU	Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users
STB	Surface Transportation Board

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United States Government Acconntability Office
Washington, DC 20548

October 6, 2006

Congressional Requesters:

Over 25 years ago, Congress transformed federal regulation of the railroad industry. After almost 100 years of economic regulation, the railroad industry was in serious economic trouble in the 1970s, with rising costs, losses, and bankruptcies. In response, Congress passed the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980. Together, these pieces of legislation substantially deregulated the railroad industry. In particular, the 1980 act encouraged greater reliance on competition to set rates and gave railroads increased freedom to price their services according to market conditions, including the freedom to use differential pricing—that is, to recover a greater proportion of their costs from rates charged to shippers with a greater dependency on rail transportation. At the same time, the 1980 act anticipated that some shippers might not have competitive alternatives—commonly referred to as "captive shippers"—and gave the Interstate Commerce Commission (ICC), and later the Surface Transportation Board (STB), the authority to establish a process so that shippers could obtain relief from unreasonably high rates. However, only a rate that produces revenue equal to at least 180 percent of the variable cost of transporting the shipment can be challenged. Since the passage of the Staggers Rail Act in 1980, we have issued several reports on the freight railroad industry.[1] These reports described the significant changes that have taken place in the railroad industry and reported that rates have generally decreased, but shippers and others have found the rate relief process long, complex, and expensive.

Policymakers continue to believe that the federal government should provide a viable process to protect shippers against unreasonably high rates, as well as address competition issues, while still balancing the interests of both railroads and shippers. Over the past 10 years, significant consolidation has taken place in the freight railroad industry, while railroads—particularly Class I railroads[2]— have seen their productivity and financial health improve. Railroad officials worry that any attempt to increase economic regulation will reduce carriers' ability to earn sufficient revenues and limit future infrastructure investment. At the same time, a number of academic and government studies are predicting a significant increase in the demand for freight rail over the next 10 to 15 years. In light of these concerns, we reviewed

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[1] See the list of related GAO products at the end of this report.

[2] As of 2004, a Class I railroad is any railroad with operating revenue above $277.7 million.

- the changes that have occurred in the freight railroad industry since the enactment of the Staggers Rail Act, including changes in rail rates and competition in the industry;
- the actions STB has taken to address concerns about competition and captivity and any alternative approaches that could be considered to address remaining concerns; and
- the projections for freight traffic demand over the next 15 to 25 years, the freight railroad industry's projected ability to meet that demand, and potential federal policy responses.

To fulfill our objectives, we examined STB's *Carload Waybill Sample* from 1985 through 2004 (the latest data available at the time of our review).[3] This database includes information on rail rates, tonnage, federal regulation, and other statistics but disguises some revenues to avoid disclosing confidential business information to the public. We obtained a version of the *Carload Waybill Sample* that did not disguise revenues. We held an expert panel consisting of 11 individuals with expertise in the freight railroad industry and the economics of transportation deregulation. Those individuals are listed in appendix I. We also interviewed, and reviewed information from, representatives of each Class I railroad in North America, shipper groups, economists, and experts in the rail industry. In addition, we reviewed pending legislation, transportation planning literature, and forecasts of future freight rail demand and capacity, including syntheses of such forecasts; and interviewed federal and state transportation officials, financial market analysts, national association representatives, and transportation experts. We determined that the data used in this report were sufficiently reliable for the purpose of our review. We conducted our review from June 2005 to August 2006 in accordance with generally accepted government auditing standards. Details of our objectives, scope, and methodology appear in appendix II.

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[3] The *Carload Waybill Sample* is a sample of railroad waybills (in general, documents prepared from bills of lading that authorize railroads to move shipments and collect freight charges); the sample contains information on rail rates.

Results in Brief

The changes that have occurred in the railroad industry since the enactment of the Staggers Rail Act are widely viewed as positive, since the financial health of the industry has improved and most rates have declined since 1985. However, concerns about competition and captivity in the industry remain. The freight railroad industry's financial health improved substantially as railroads cut costs through productivity improvements; streamlined and right-sized their rail networks; implemented new technologies; and expanded business into new markets, such as the intermodal market.[4] Between 1985 and 2000, rail rates generally declined, but then increased slightly from 2001 through 2004.[5] Although rates have declined since 1985, they have not done so uniformly, and rates for some commodities are significantly higher than rates for others. Several factors could have contributed to recent rate increases, including broad changes in the domestic and world economy, the emergence of a capacity-constrained environment in which demand exceeds supply, and consolidation in the 1990s in the industry leading to changes in competition. Other costs, such as fuel surcharges, have also shifted to shippers, and STB has not clearly tracked the revenues the railroads have raised from some of these charges. Some concerns about competition and captivity in the industry remain because traffic is concentrated in fewer railroads. It is difficult to determine precisely how many shippers are captive because available proxy measures can overstate or understate captivity. In addition, STB does not accurately collect railroad revenue data. Nevertheless, our analysis of available measures indicates that the extent of captivity appears to be dropping, but the percentage of industry traffic traveling at rates substantially over the statutory threshold for rate relief has increased. For example, the amount of traffic traveling at rates over 300 percent of the railroad's variable cost increased from 4 percent in 1985 to 6 percent in 2004. Furthermore, some areas with access to one Class I railroad have higher percentages of traffic traveling at rates that exceed the statutory threshold for rate relief. These findings may reflect reasonable economic practices by the railroads in an environment of excess demand, or they may indicate a possible abuse of market power. We are recommending that STB conduct a rigorous analysis of the state of competition nationwide and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power. In addition, we are recommending that STB review its method of data collection to ensure consistent and accurate reporting of railroad revenues, including fuel surcharges.

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[4] The intermodal market consists of containers and trailers that can be carried on ships, trucks, or rail.

[5] While rate data are not available for 2005 and 2006, shippers, railroads, and financial analysts with whom we spoke told us that rates have generally increased during those years.

STB has taken a number of actions to improve the rate relief process and assess competition, but further actions could help address remaining competition and captivity concerns. The Staggers Rail Act and the ICC Termination Act encouraged competition as the preferred method to protect shippers from unreasonable rates and granted STB broad legislative authority to monitor the performance of the railroad industry. Under this authority, STB established both a standard and a simplified rate relief process so that captive shippers could obtain relief from unreasonable rates. However, these processes have proven to be largely inaccessible because the standard process is expensive, time consuming, and complex, and the simplified process has not been used. During our review, STB took steps to refine its processes, including issuing a proposed rule making to clarify eligibility for the simplified process. Ultimately, our analysis suggests a reasonable possibility that shippers in selected markets may be paying excessive rates, and an assessment of competition would determine if this situation reflects reasonable economic practices by the railroads in an environment of excess demand or an abuse of market power. This assessment could also provide further information about the extent of captivity and the merits of proposed approaches to enhance the competitive options available to shippers. These approaches—such as providing trackage rights to allow a railroad to run on another railroad's track for a fee— have been suggested by shipper groups, economists, and others. Each of these approaches has costs and benefits and should be carefully considered to ensure that the approach is designed to achieve the balance set out in the Staggers Rail Act, including consideration of the revenue adequacy of the railroads. However, not all markets may have the demand needed to support competition among railroads, and so some areas where shippers are captive are likely to persist. In this regard, there are also a number of proposals to make the rate relief process more accessible, such as the increased use of arbitration to settle disputes, and each of these proposals has advantages and drawbacks.

Significant increases in freight traffic over the next 10 to 15 years are forecasted, and the railroad industry's ability to meet future demand is largely uncertain. Investments in rail projects can produce benefits for the public—for example, shifting truck freight traffic to railroads can reduce highway congestion. To obtain such benefits, governments have increasingly been participating in freight rail improvement projects. For example, Missouri state and local governments supported two major rail-bridge projects to reduce delays in Kansas City. At the federal level, Congress, in 2005, provided $100 million for rail infrastructure improvements in the Chicago area. In the years ahead, Congress is likely to receive further requests for funding and face additional decisions about potential federal policy responses and the federal role in the nation's freight railroad infrastructure. Such policy responses need to recognize that the freight transportation system encompasses many modes that are treated differently by the federal government and are on systems owned, funded, and operated by both the public and private sectors. Furthermore, the freight transportation system functions in a competitive marketplace, and the federal fiscal funding environment is highly constrained. As a result, policy and decision makers are challenged to ensure that federal involvement is consistent with competition in the freight marketplace and that federal funding decisions reflect widespread public priorities. In developing a draft National Freight Policy, the Department of Transportation (DOT) has made a good start by providing a context for decisions about how to apply a more strategic, systemwide approach, in general, and how to craft a federal policy response to freight rail investment needs in particular. We are recommending that DOT, as it continues to draft a National Freight Policy, consider strategies to sustain the role of competitive market forces by creating a level playing field for all freight modes and recognize the highly constrained federal fiscal environment by developing mechanisms to assess and maximize public benefits from federally financed freight transportation investments.

We provided a draft of this report to DOT and STB. In oral comments, DOT took no position on our recommendation related to the National Freight Policy. In written comments, STB stated that it has already responded to our recommendation on its method of data collection through a proposed rule making on collecting fuel surcharge data. While we commend STB for its proposed rule making, STB has not yet implemented this change, and other revenues may still not be accurately tracked. STB also disagreed with our recommendation to conduct a rigorous analysis of competitive markets to identify the state of competition nationwide, inquire into pricing practices in specific markets, and consider appropriate actions available to address problems associated with the potential abuse of market power. STB commented that this recommendation was based on inconclusive findings and would divert resources away from current initiatives. We disagree that our recommendation was based on inconclusive findings. Our analysis of multiple sources suggests a reasonable possibility that shippers in some markets may be paying excessive rates. We believe that such a possibility merits further inquiry and analysis. We recognize that STB has limited resources and modified our draft to recommend that STB request additional resources from Congress if it determines that it needs more resources to conduct an analysis of competition. STB also stated that it has several rule makings under way that are designed to improve the rate relief process and would address many of our concerns. STB stated that it would be far more practical for STB to finish these reforms to ensure that captive shippers have an effective forum to seek rate relief. While we commend STB for recognizing and taking action to address problems with the rate relief process, we believe action beyond improvements to the rate relief process is needed. In particular, these STB rule makings are designed to improve processes available to shippers after they have been charged a rate they consider to be unreasonable. In contrast, we believe that an analysis of the state of competition and the possible abuse of market power, along with the range of options STB has to address competition issues, could more directly further the legislatively defined goal of ensuring effective competition among rail carriers. STB's comments are in appendix III.

Background

In the past, the ICC regulated almost all of the rates that railroads charged shippers. The Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 greatly increased reliance on competition to set rates in the railroad industry. Specifically, these acts allowed railroads and shippers to enter into confidential contracts that set rates and prohibited ICC from regulating rates where railroads had either effective competition or rates negotiated between the railroad and the shipper. Furthermore, the ICC Termination Act of 1995 abolished ICC and transferred its regulatory functions to STB. Taken together, these acts anchor the federal government's role in the freight rail industry by establishing numerous goals for regulating the industry, including to

- allow, to the maximum extent possible, competition and demand for services to establish reasonable rates for transportation by rail;
- minimize the need for federal regulatory control over the rail transportation system and require fair and expeditious regulatory decisions when regulation is required;
- promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by STB;

- ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes to meet the needs of the public and the national defense;
- foster sound economic conditions in transportation and ensure effective competition and coordination between rail carriers and other modes:
- maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues that exceed the amount necessary to maintain the rail system and attract capital;
- prohibit predatory pricing and practices to avoid undue concentrations of market power; and
- provide for the expeditious handling and resolution of all proceedings.

While the Staggers Rail and ICC Termination Acts reduced regulation in the railroad industry, they maintained STB's role as the economic regulator of the industry. The federal courts have upheld STB's general powers to monitor the rail industry, including its ability to subpoena witnesses and records and to depose witnesses. In addition, STB can revisit its past decisions if it discovers a material error, or new evidence, or if circumstances have substantially changed.

Two important components of the current regulatory structure for the railroad industry are the concepts of revenue adequacy and demand-based differential pricing. Congress established the concept of revenue adequacy as an indicator of the financial health of the industry. STB determines the revenue adequacy of a railroad by comparing the railroad's return on investment with the industrywide cost of capital. For instance, if a railroad's return on investment is greater than the industrywide cost of capital, STB determines that railroad to be revenue adequate. Historically, ICC and STB have rarely found railroads to be revenue adequate—a result that many observers relate to characteristics of the industry's cost structure. Railroads incur large fixed costs to build and operate networks that jointly serve many different shippers. Some fixed costs can be attributed to serving particular shippers, and some costs vary with particular movements, but other costs are not attributable to particular shippers or movements. Nonetheless, a railroad must recover these costs if the railroad is to continue to provide service over the long run. To the extent that railroads have not been revenue adequate, they may not have been fully recovering these costs.

The Staggers Rail Act recognized the need for railroads to use demand-based differential pricing to promote a healthy rail industry and enable it to raise sufficient revenues to operate, maintain and, if necessary, expand the system in a deregulated environment. Demand-based differential pricing, in theory, permits a railroad to recover its joint and common costs—those costs that exist no matter how many shipments are transported, such as the cost of maintaining track— across its entire traffic base by setting higher rates for traffic with fewer transportation alternatives than for traffic with more alternatives. Differential pricing recognizes that some customers may use rail if rates are low—and have other options if rail rates are too high or service is poor. Therefore, rail rates on these shipments generally cover the directly attributable (variable) costs, plus a relatively low contribution to fixed costs. In contrast, customers with little or no practical alternative to rail—"captive" shippers—generally pay a much larger portion of fixed costs. Moreover, even though a railroad might incur similar incremental costs while providing service to two different shippers that move similar volumes in similar car types traveling over similar distances, the railroad might charge the shippers different rates. Furthermore, if the railroad is able to offer lower rates to the shipper with more transportation alternatives, that shipper still pays some of the joint and common costs. By paying even a small part of total fixed cost, competitive traffic reduces the share of those costs that captive shippers would have to pay if the competitive traffic switched to truck or some other alternative. Consequently, while the shipper with fewer alternatives makes a greater contribution toward the railroad's joint and common costs, the contribution is less than if the shipper with more alternatives did not ship via rail.

The Staggers Rail Act further requires that the railroads' need to obtain adequate revenues to be balanced with the rights of shippers to be free from, and to seek redress from, unreasonable rates. Railroads incur variable costs—that is, the costs of moving particular shipments—in providing service. The Staggers Rail Act stated that any rate that was found to be below 180 percent of a railroad's variable cost for a particular shipment could not be challenged as unreasonable and authorized ICC, and later STB, to establish a rate relief process for shippers to challenge the reasonableness of a rate. STB may consider the reasonableness of a rate only if it finds that the carrier has market dominance over the traffic at issue—that is, if (1) the railroad's revenue is equal to or above 180 percent of the railroad's variable cost (R/VC) and (2) the railroad does not face effective competition from other rail carriers or other modes of transportation.

Railroad Industry Increasingly Healthy and Rates Generally Down Since Enactment of the Staggers Rail Act, but Concerns about Competition and Captivity Remain

The changes that have occurred in the railroad industry since the enactment of the Staggers Rail Act are widely viewed as positive. The railroad industry's financial health improved substantially as it cut costs, boosted productivity, and right-sized its networks. Rail rates generally declined between 1985 and 2000 but increased slightly from 2001 through 2004. Likewise, rail rates have declined since 1985 for certain commodity groups and routes despite some increases since 2001, but rates have not declined uniformly, and some commodities are paying significantly higher rates than others. For example, from 1985 through 2004, coal rates declined 35 percent while grain rates increased 9 percent.[6] Concerns about competition and captivity in the industry remain because traffic is concentrated in fewer railroads. It is difficult to determine precisely how many shippers are captive to one railroad. Nevertheless, our analysis indicates that the extent of potential captivity appears to be dropping, but that the percentage of all industry traffic running at rates substantially over the statutory threshold for rate relief—traffic traveling at rates over 180 percent R/VC—has increased. Furthermore, some areas with access to only one Class I railroad have higher percentages of traffic traveling at rates that exceed the statutory threshold for rate relief. This situation may reflect reasonable economic practices by the railroads in an environment of excess demand, or it may represent an abuse of market power.

Railroad Industry's Financial Health Has Improved Substantially

There is widespread consensus that the freight rail industry has benefited from the Staggers Rail Act. Ten of the 11 members of our expert panel believed that the Staggers Rail Act has had a strongly positive overall effect on freight railroad companies, while 8 believed the Staggers Rail Act had a strongly positive effect on shipping companies. In addition, various measures indicate an increasingly strong freight railroad industry. Freight railroads' improved financial health is illustrated by a general increase in return on investment since 1980, as shown in figure 1.[7] Freight railroads have also cut costs by streamlining their workforces; right-sizing their rail networks; and reducing track miles, equipment, and facilities to more closely match demand.[8]

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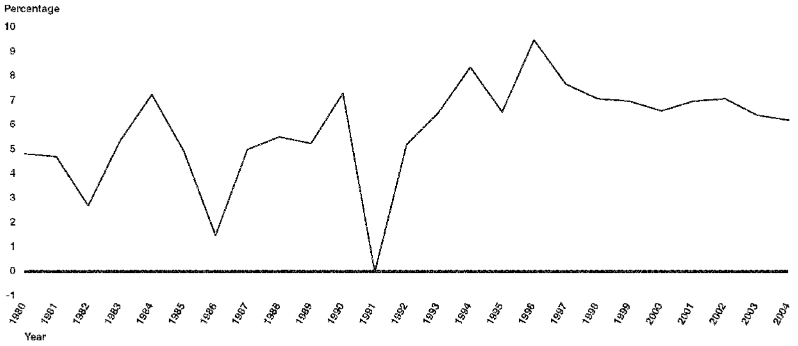
[6] All of our rate changes—increases and decreases—are presented in nominal terms.

[7] Return on investment measures the profit made on assets used to provide transportation services. Return on investment is based on STB's methodology for determining revenue adequacy.

Figure 1: Railroads' Tax-Adjusted Return on Investment, 1980-2004



Source: STB.

Freight railroads have also expanded their business into new markets—such as the intermodal market—and implemented new technologies, including larger cars, and are currently developing new scheduling and train control systems. Some observers believe that the competition faced by railroads from other modes of transportation has created incentives for innovative practices, and that the ability to enter into confidential contracts with shippers has permitted railroads to make specific investments and to develop service arrangements tailored to the requirements of different shippers.[9]

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[8] Clifford Winston, *Deregulation of Network Industries – What's Next?* (Washington: AEI-Brookings Joint Center for Regulatory Studies: 2000), pp. 43-44.

[9] Gallamore, pp. 511-515.

Freight rail is an important component of our nation's economy. Approximately 42 percent of all intercity freight in the United States, measured in ton-miles,[10] moves on rail lines. Freight rail is particularly important to producers and users of certain commodities. For example, about 70 percent of automobiles manufactured domestically and about 70 percent of coal delivered to power plants moves on freight rail.

Industrywide Rates Declined from 1985 through 2000 and Rose Slightly from 2001 through 2004

Rail rates across the freight railroad industry have generally declined since the enactment of the Staggers Rail Act. Because changes in traffic patterns over time (for example, hauls over longer distances) can result in a decrease in the average revenue per ton-mile, purely relying on cents per ton-mile can present misleading industrywide rate trends. Therefore, we developed a set of rail rate indexes[11] to examine trends in rail rates over the 1985 through 2004 period. These indexes account for changes in traffic patterns over time that could affect revenue statistics but do not account for inflation. To provide a measure for inflation, we also included the price index for the gross domestic product (GDP) in figure 2.

From 1985 through 1987, rail rates dropped by 10 percent and then continued to decline, although not as steeply, through 1998. Rates increased in 1999, then dropped again in 2000. In 2001 and 2002 rates rose again. Rates were nearly flat in 2003 and 2004, finishing approximately 3 percent above rates in 2000, but were 20 percent below 1985 rates (These trends are shown in figure 2). While our rail rate index does not reflect the general effects of inflation, the continuous increases in the GDP price index over this period indicate that real rates decreased by more than 20 percent from 1985 through 2004. Rate data are not available for 2005 and 2006, but shippers, railroad officials, and financial analysts with whom we spoke told us that rates have generally increased during those years.

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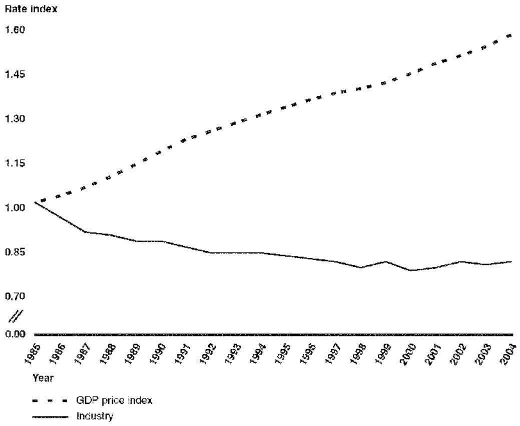
[10] A ton-mile is a standard industry measure that represents 1 ton of freight transported 1 mile.

[11] We constructed rate indexes to examine trends in rail rates over the 1985 to 2004 period. These indexes define traffic patterns for a given commodity in terms of census region to census region flows of that commodity, and we calculated the average revenue per ton-mile for each of these traffic flows. The index is calculated as the weighted average of these traffic flows in each year, expressed as a percentage of the value for 1985, where the weights reflect the traffic patterns in 2004. By fixing the weights as of one period of time, we attempted to measure pure price changes rather than calculating the average revenue per ton-mile in each year. Over time, changes in traffic patterns could result in a substitution of lower priced traffic for higher priced traffic, or vice versa, so that a decrease in average revenue per ton-mile might partly reflect this change in traffic patterns. The rate index for the overall industry was defined similarly, except that the traffic pattern bundle was defined in terms of broad commodity, census region of origin, and mileage block categories. For comparison purposes, we also present the price index for gross domestic product over this period.

Figure 2: Trends in Industry Rail Rates, 1985-2004

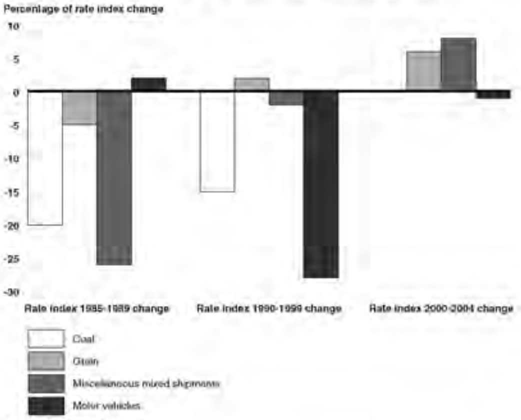


Source: GAO analysis of STB data.

For Many Commodities and Particular Routes, Rates Have Also Declined Since 1985, but Declines Are Not Uniform

Similar to industrywide changes in rail rates, the rates for many commodities have declined since 1985 and have recently increased. In 2004, four commodities each made up 5 percent or more of freight railroad revenue—grain, coal, motor vehicles, and miscellaneous mixed shipments. In both the 1985 through 1989 and the 1990 through 1999 intervals, the rates for most of these commodities declined, while in 2000 through 2004, the rates increased for two commodities and decreased for two (see fig. 3).

Figure 3: Commodity Rate Changes, 1985-1989, 1990-1999, and 2000-2004

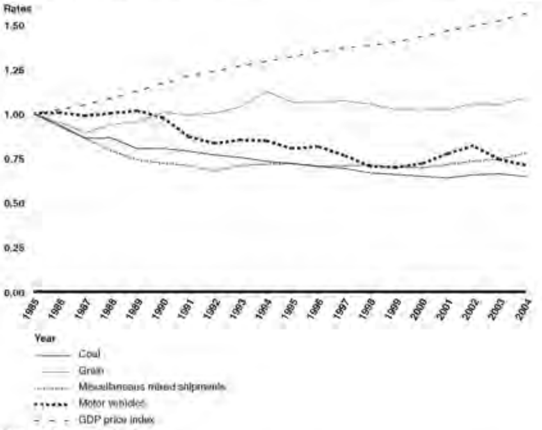


Source: GAO analysis of STB data.

Note: From 2000 to 2004, the rate index for coal was largely unchanged.

Although many rates have decreased, rates have not declined uniformly, and rates for some commodities are significantly higher than for others. Figure 4 compares commodity rates for coal, grain, miscellaneous mixed shipments, and motor vehicles from 1985 through 2004 using our rail rate index. Over the 20-year period most rates declined, with coal rates dropping the most sharply by 35 percent. Miscellaneous mixed shipments and motor vehicle rates also declined, although to a lesser extent than coal rates. Grain rates initially declined from 1985 through 1987, but then diverged from the other commodity trends and increased, resulting in a net 9 percent increase by 2004.

Figure 4: Rate Changes for Coal, Grain, Miscellaneous Mixed Shipments, and Motor Vehicles, 1985-2004



Source: GAO analysis of STB data.

We examined rate changes for commodities traveling along hundreds of particular routes and found that the rates on a majority of the routes we analyzed decreased from 2000 through 2004. Figure 5 shows that from 2000 through 2004 rail rates decreased on about 55 percent of the routes in our analysis[12] (334 of 604 routes). More specifically, the rates for most long-distance (over 1,000 miles) and medium-distance (501 to 1,000 miles) routes decreased. In one distance category, short-distance routes (up to 500 miles), there were more routes with increases (103) than decreases

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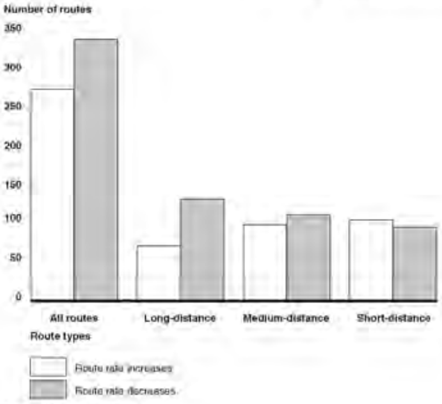
[12] Our initial route universe consisted of 932 commodity routes, but we removed 328 routes that did not have large enough samples in some years to be valid, or they were not collected in the *Carload Waybill Sample* in either 2000 or 2004.

(94), from 2000 through 2004. While figure 5 shows that, for the long-distance routes we examined, the number of routes with rate decreases was nearly twice the number of routes with rate increases. Many of the largest rate increases were on long-distance routes carrying miscellaneous mixed shipments—which include intermodal goods—that originated in the Los Angeles-Long Beach-Riverside, California, economic area and terminated at various destinations across the country. Several shipper groups reported that many rate increases occurred after 2004; however, data are not available for 2005 and 2006.

Figure 5: Rail Rate Increases and Decreases across 604 Routes, and for Long-, Medium-, and Short-distance Routes, 2000 through 2004



Source: GAO analysis of STB data.

Many Factors May Have Contributed to Recent Rate Increases

Several factors could have contributed to recent rate increases. Ongoing industry and economic changes have influenced how railroads have set their rates. Since the Staggers Rail Act was enacted, the railroad industry and the economic environment in which it operates have changed considerably. After years of reducing the size of its workforce and shedding track capacity, the industry is increasingly operating in a capacity-constrained environment in which the demand for its services exceeds its capacity in some areas. In addition, the industry has more recently increased employment and invested in increased capacity in key traffic corridors. Additionally, changes in broader domestic and world economic conditions have led to changes in the mix and profitability of traffic carried by railroads. For example, railroads have developed high-volume traffic by shipping import and export containers, leading them to price these shipments differently. According to DOT officials, some shippers—such as those in the automobile and chemical industries—may pay higher rates in order to secure higher quality service or due to liability issues. Lastly, the rail industry has continued to consolidate, potentially increasing the market power of the largest railroads. Our analysis included rate data through 2004,[13] and according to freight railroad officials, shippers, and financial analysts, since 2004, rates have continued to increase as the demand for freight rail service has increased, and rail capacity has not kept pace with demand.

Other Costs Have Shifted to Shippers, and Some Charges Are Not Accurately Tracked

While rates have generally decreased since 1985, other costs have been passed on to shippers, some of which STB has not accurately tracked. Several shippers with whom we spoke agreed that rates have dropped over the long-term, but they also said that rates do not reflect the total cost of shipping by rail. According to some shippers, costs have shifted from the railroads to shipping companies, including the costs of railcar ownership. Figure 6 shows that tons carried by railcar ownership has shifted nearly 20 percent since 1985, indicating less tonnage shipped on railcars owned by freight railroad companies.

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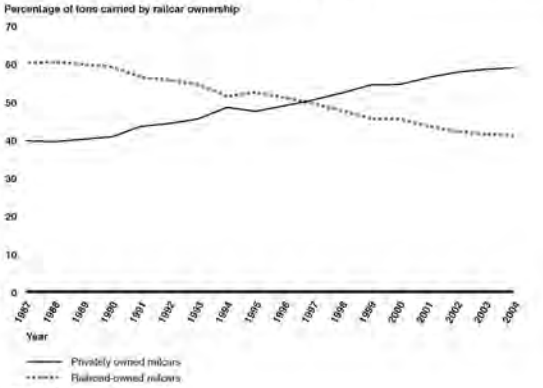
[13] According to STB officials, the 2005 waybill data will become available in Fall 2006.

Figure 6: Tonnage Carried by Railcar Ownership, 1987-2004



Source: GAO analysis of STB data.

Besides rates, other costs that shippers reported were infrastructure upgrade costs, fuel surcharges,[11] and congestion fees. Conversely, one Class I railroad told us that some rates in the *Carload Waybill Sample* do not account for rebates or incentives that may change the actual rate paid by the shipper. We are unable to report on the full extent of all costs because STB has not accurately tracked the railroad revenues associated with some of these charges. For example, freight railroad companies do not consistently report revenues raised from fuel surcharges for use in the *Carload Waybill Sample*. Some railroads report fuel surcharges as part of their general revenues, while others categorize the surcharges separately under a miscellaneous revenue category, and still other railroads may not report revenue collected from fuel surcharges at all. Shippers have expressed deep concerns over how fuel surcharges relate to actual fuel costs. Other railroad revenues, such as those generated at railcar auctions[15] and through congestion fees, may not be included in the waybill sample either. Understanding what railroads do and do not report as miscellaneous revenue in the waybill sample may be of increasing importance because fuel surcharges have become more prevalent, and railroad revenue reported as miscellaneous revenue has substantially risen in recent years. From 2000 through 2004, the miscellaneous revenue reported in the waybill sample has more than quadrupled in value, from $141 million to $614 million (see fig. 7). Although an increase in value, $614 million still represents less than 1.5 percent of the approximately $42 billion in freight railroad revenue reported for 2004. Since 2004, miscellaneous revenue may have further increased as railroad and shipper groups with whom we spoke said that many fuel surcharge increases took effect in 2005. During our review, STB proposed to more closely track and otherwise monitor revenues associated with fuel surcharges.

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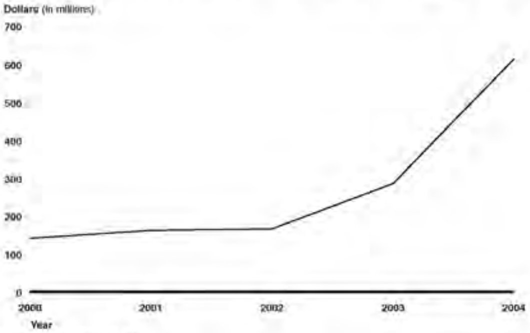
[11] Fuel surcharges are charges associated with recouping the cost of fuel. How fuel surcharges are calculated varies among Class I railroads because some use a mileage-based system while others use a percentage of the base rate.

Figure 7: Miscellaneous Revenue Tracked in Carload Waybill Sample, 2000-2004



Source: GAO analysis of STB data.

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[15] At railcar auctions, railroad companies auction to the highest bidder the guaranteed delivery of a set number of railcars at specified future delivery dates. If railroads fail to deliver the railcars at the specified time, the railroads may pay a penalty to the shippers; if shippers find they cannot use the railcars at the time delivered then the shipper may pay a penalty to the railroad.

Competition and Captivity Concerns Remain

Concerns about competition and captivity in the railroad industry remain because traffic is concentrated in fewer railroads, although there is disagreement on the state of competition in the industry. It is difficult to determine the number of captive shippers, because proxy measures can overstate or understate captivity, but our analysis of available measures indicates that the extent of captivity is dropping. At the same time, the percentage of all industry traffic running substantially over the statutory threshold for rate relief has increased from about 4 percent of tonnage in 1985 to about 6 percent of tonnage in 2004. Furthermore, some economic areas with access to one Class I railroad have higher percentages of traffic traveling at rates that exceed the statutory threshold for rate relief.

The Freight Railroad Industry Has Become More Concentrated

During the past 30 years, the freight railroad industry has become more concentrated. In 1976, there were 30 independent Class I railroad systems, consisting of 63 Class I railroads operating in the United States. Currently there are seven railroad systems, consisting of seven Class I railroads. Nearly half of that reduction was attributable to consolidations.[16] The railroad industry is dominated by four Class I railroads—two in the East and two in the West. As figure 8 shows, the market share of these four Class I railroads has been increasing and accounted for over 89 percent of the industry's revenues in 2004.

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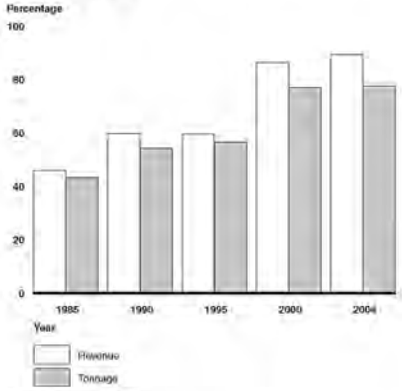
[16] Other reasons for the reduction in the number of Class I railroads include carrier bankruptcies and a series of changes in the threshold for qualifying as a Class I railroad (from $5 million in annual revenue in 1976 to $250 million in 1992).

Figure 8: Percentage of Railroad Market Represented by Four Largest Class I Railroads, 1985-2004



Source: GAO analysis of STB data.

There is significant disagreement on the state of competition in the rail industry and on whether or not federal regulation—resulting from legislation such as the Staggers Rail Act—has ensured effective competition among railroads. This disagreement was represented on our panel of 11 experts, 6 of whom indicated that rail-to-rail competition has been achieved (either "greatly" or "somewhat") and 4 of whom maintained that effective competition had not been achieved.[17] One member of our panel viewed less competition among rail carriers as a negative development because it can result in less efficient railroad companies and fewer options for shipping companies. Another member of our panel said that industry consolidation was essential to achieving an efficient and complete rail network under fewer, but ultimately stronger, railroad companies. Other experts also pointed to the hundreds of short-line railroads[18] that have come into being since the enactment of the Staggers Rail Act, as well as increases in other competitive options for shippers from other modes such as trucks and barges.

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[17] One participant did not respond to this question.

A reduction in competitive options can have a significant impact on the rates railroads charge shippers. There are a variety of contexts that affect how railroads compete with each other and with other modes, such as when route origins and destinations can both be reached by more than one railroad, or by multiple modes of transportation.[19] Comparing two routes for shipping the same commodity, but using a different number of rail carriers, can illustrate this effect. Figure 9 shows two long-distance grain routes that both terminate in the Portland, Oregon, economic area from different origin points. Both routes carry comparable tonnage, but the route originating in the economic area in and around Sioux Falls, South Dakota, is served by two Class I railroads, whereas the route from the Minot, North Dakota, economic area is served by one Class I railroad. The rates for the Minot route are roughly double the rates for the Sioux Falls route.

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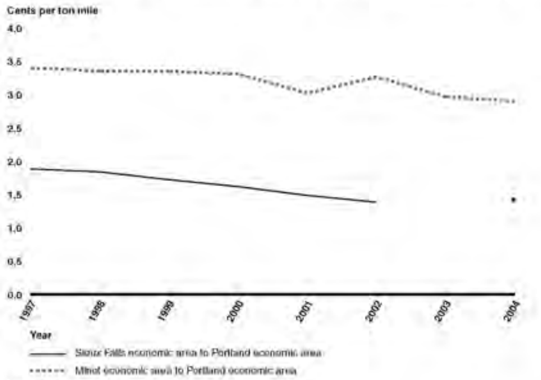
[18] A short-line railroad is an independent railroad company that operates over a short distance.

[19] Winston, pp. 54-57.

Figure 9: Comparison of Rates Charged on Long-distance Grain Routes, 1997-2004



Source: GAO analysis of STB data.

Note: For some years, data have been removed due to insufficient sample size.

The ability to build out to another railroad can also create competition and improve railroad rates for some shippers. For example, following a build-out,[20] a shipper gained access to a second railroad at an origin point that had previously been served by one Class I railroad.[21] Figure 10 shows that within a few years after the introduction of service by the second railroad, the rates had dropped significantly. Because even a short segment build-out can be quite costly, shippers are unlikely to pursue build-out options without a substantial traffic base. Some experts with whom we spoke said that situations like the one depicted in figure 9 reflect the reality of differential pricing in the freight railroad industry, or they suggest that other factors such as differences in the length of two different routes may be the cause of rate discrepancies. Others believe that a significant rate decrease after the introduction of competition is evidence that railroads are extracting monopoly rates from captive shippers.

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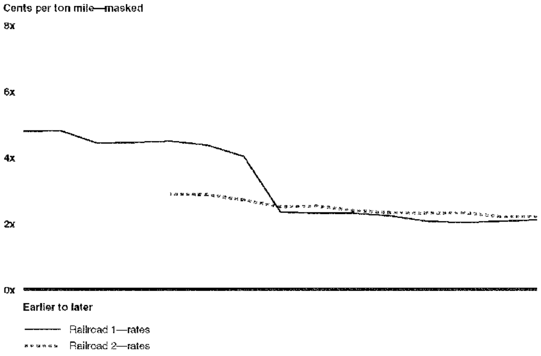
[20] A build-out is a shipper's option to build (or have some other party build) a track connection to a competing railroad.

[21] We do not provide information identifying the location or the shipper involved because doing so could reveal proprietary information.

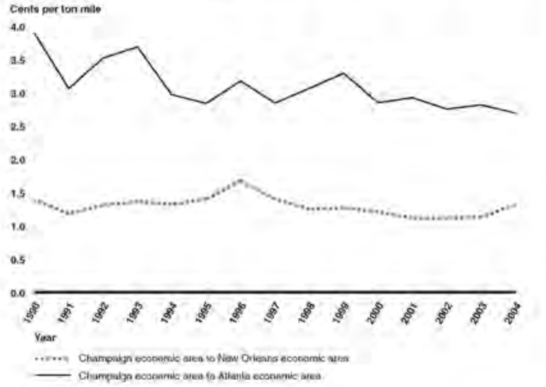
Figure 10: Rate Changes after the Introduction of a Second Carrier



Source: GAO analysis of STB data.

While competition between rail carriers is particularly important in some cases, in other cases, competition between rail and other transportation modes, such as trucks and barges, may be more important. Particularly for bulk commodities (i.e., grain), when shipper locations can be served by barge transportation, rail rates will be lower relative to rail costs than on routes that are not conducive to barge competition. Figure 11 depicts costs and revenues for two routes, one (from the Champaign, Illinois economic area to the New Orleans, Louisiana economic area) with rail and barge options, and the other (from the Champaign, Illinois economic area to the Atlanta, Georgia economic area) with just a rail option. Although both routes have the same origin, for shipping the same commodity over a comparable distance, the route with the barge option has consistently lower rates than the route with just rail service.

Figure 11: Comparison of Rate Changes from Champaign, Illinois, Economic Area to New Orleans, Louisiana, Economic Area and Champaign, Illinois, Economic Area to Atlanta, Georgia, Economic Area, 1990-2004



Source: GAO analysis of STB data.

Besides the number of rail carriers serving a location, the use of contracts for rail service can affect the competitive landscape. The Staggers Rail Act allowed railroad and shipping companies to enter into confidential contracts for rail service and also placed all traffic running under contract outside the remaining rate regulations. According to railroad and shipper groups, the duration of contracts has declined, in part because of the railroads' desire to quickly react to shifting market demand, which can result in charging higher rates. Other shippers were concerned that moving away from confidential contracts to public pricing could represent price signaling and further reduce competition between railroads. In 2004, 70 percent of tonnage and 71 percent of industry revenue moved under contract.

Captive Shippers Are Difficult to Identify, but Available Measures Indicate Captivity Dropping in the Railroad Industry

It is difficult to determine precisely how many shippers are "captive" to one railroad because the proxy measures that provide the best indication can overstate or understate captivity.[22] One way of determining potential captivity is to identify which Bureau of Economic Analysis (BEA) economic areas were served by only one Class I railroad.[23] In 2004, 27 of the 177 BEA economic areas were served by only one Class I railroad.[24] As shown in figure 12, these areas include parts of Montana, North Dakota, New Mexico, Maine, and smaller areas in several states.

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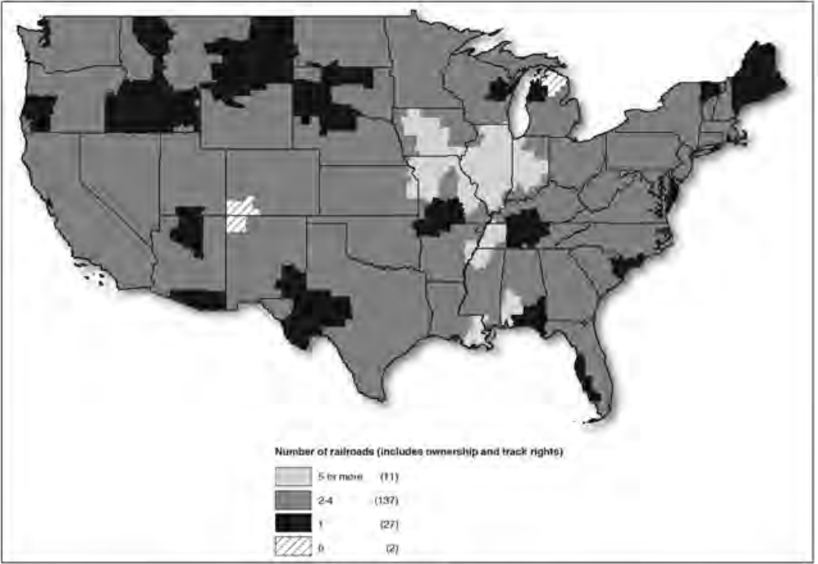
[22] Jerry Ellig, "Railroad Deregulation and Consumer Welfare," *Journal of Regulatory Economics* (The Netherlands: Klower Academic Publishers: 2002), p. 156.

[23] Economic areas are those areas defined by BEA, which defines the relevant regional economic markets in the United States.

[24] The number of carriers serving a given location is not indicated in the *Carload Waybill Sample*. We obtained this additional information from DOT.

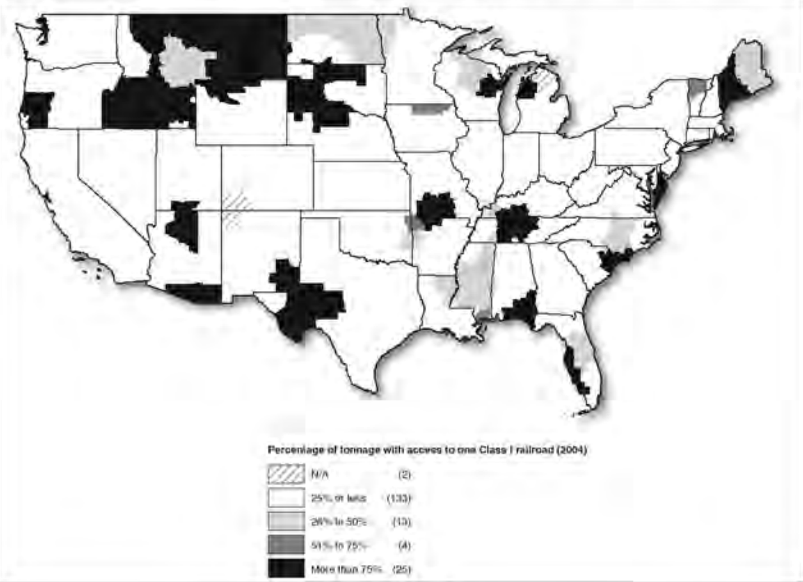
Figure 12: Number of Class I Railroads Serving Economic Areas, 2004



Source: GAO analysis of BEA and GIS data.

Another way of looking at potential captivity is to calculate how much route tonnage originating in a given economic area has access to only one Class I railroad. Figure 13 shows the percentage in 2004 of all industry tonnage originating in economic areas with access to only one Class I railroad. In particular, economic areas with more than 75 percent of tonnage shipped on one railroad appear most prevalent in states such as Montana, Idaho, North Dakota, and Texas. Tonnage originating in these economic areas varies widely, from a little over 55,000 tons to over 36 million tons.

Figure 13: Percentage of All Industry Tonnage Originating in Economic with Access to One Class I Railroad, 2004



Source: GAO analysis of BEA, DOT and STB data.

According to our analysis of available measures, the overall extent of captivity appears to be dropping in the freight railroad industry. We examined tonnage, revenue, and access statistics for all routes—originating and terminating in economic areas—captured in the *Carload Waybill Sample* and other DOT data. In 2004, origin and destination routes with access to only one Class I railroad carried 12 percent of industry revenue and 10 percent of industry tonnage, which represents a decline from 1994, when 22 percent of industry revenue and 21 percent of industry tonnage moved on routes served by one Class I railroad (see table 1).[25]

Table 1: Changes in Percentage of Industry Revenue and Tonnage on Origin and Destination Routes with Access to One Class I Railroad

Year	Percentage of revenue	Percentage of tonnage
1994	22.87	20.59
2004	12.29	10.43

Source: GAO analysis of BEA, DOT, and STB data.

This decline suggests that more railroad traffic is traveling on routes with access to more than one Class I railroad. While overall industry tonnage with access to more than one Class I railroad appears to have increased, some economic areas have a higher percentage of all industry traffic tonnage shipping on one Class I railroad. From 1994 through 2004, parts of states such as Texas, Tennessee, and Montana experienced increases of 25 percent or more in tonnage with access to one Class I railroad while parts of other states such as Oregon, New York, and Florida saw their percentages of tonnage with access to one Class I railroad drop by more than 25 percent (see fig. 14).

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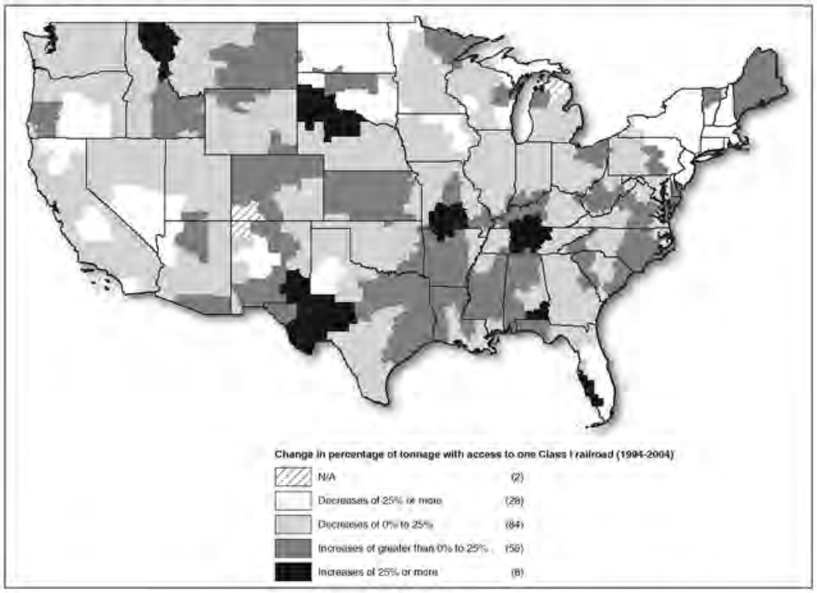
[25] For our analysis of access to one or more Class I railroads, we examined data for 1994 and 2004, the earliest and latest years for which such data were available.

Figure 14: Changes in Percentage of All Industry Traffic Tonnage with Access to One Class I Railroad Originating in Economic Areas, 1994 through 2004


Change in percentage of tonnage with access to one Class I railroad (1994-2004)
▨ N/A (2)
☐ Decreases of 25% or more (28)
Decreases of 0% to 25% (84)
Increases of greater than 0% to 25% (56)
■ Increases of 25% or more (8)

Source: GAO analysis of BEA, DOT, and STB data.

While examining BEA areas provides a proxy measure for captivity, a number of factors may understate or overstate whether shippers are actually captive. The first three factors may work to understate the extent of captivity among shippers. First, routes originating within economic areas served by multiple Class I railroads may still be captive if only one Class I railroad serves their destination, and a shipper must use that one railroad for that particular route. Second, some BEA areas are quite large, so a shipper within the area may have access to only one railroad, even though there are two or more railroads within the broader area. Third, an origin may only be served by one Class I railroad, but one Class I railroad does not serve the entire route, meaning the route may be partially captive, although more than one Class I railroad provides service between its origin and destination. Two additional limitations may work to overstate the number of locations captive to one railroad. First, this analysis accounts for Class I railroads only and does not account for competitive rail options that might be offered by Class II or III railroads[26] such as the Guilford Rail System, which operates in northern New England. Second, this analysis considers only competition among rail carriers and does not examine competitive options offered by rail and other transportation alternatives such as trucks and barges.

Amount of Potentially Captive Traffic Traveling at Rates at Levels Substantially above the Threshold for Rate Relief Has Increased

To determine potential captivity, we applied another measure— traffic traveling at rates equal to or greater than 180 percent R/VC, which is part of the statutory threshold for bringing a rate relief case before STB. STB regards traffic at or above this threshold as "potentially captive." As with BEA areas, examining R/VC levels as a proxy measure for captivity can also understate or overstate captivity. For example, it is possible for the R/VC ratio to increase while the rate paid by a shipper is declining. Assume that in Year 1, a shipper is paying a rate of $20 and the railroad's variable cost is $12; the R/VC ratio—a division of the rate and the variable cost—would be 167 percent. If in Year 2, the variable costs decline by $2 from $12 to $10 and the railroad passes this cost savings directly on to the shipper in the form of a reduced rate, the shipper would pay $18 instead of $20. However, as shown in table 2, because both revenue and variable cost decline, the R/VC ratio increases to 180 percent.

Table 2: Possible Changes in R/VC Ratios

Year	Revenue collected	Variable costs	R/VC
Year 1	$20.00	$12.00	167%
Year 2	$18.00	$10.00	180%

Source: GAO.

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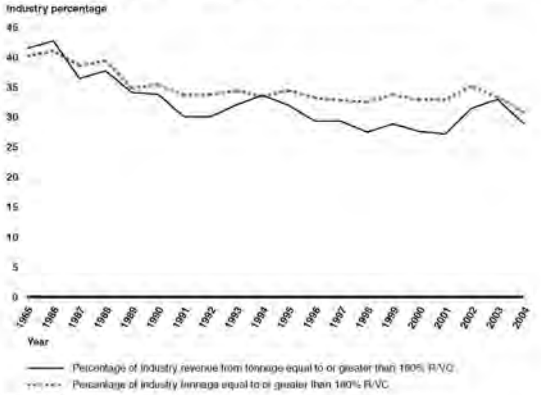
[26] STB classifies railroads according to operating revenues. Class II railroads had revenues of $20 million to $250 million, and class III railroads had revenues of less than $20 million in 1991 dollars.

Since 1985, and as a percentage of all traffic, the amount of potentially captive traffic traveling at rates over 180 percent R/VC and the revenue generated from that traffic have both declined. Revenue generated from traffic traveling at rates over 180 percent R/VC decreased from 41 percent of all industry revenue in 1985 to 29 percent in 2004 (see fig. 15).

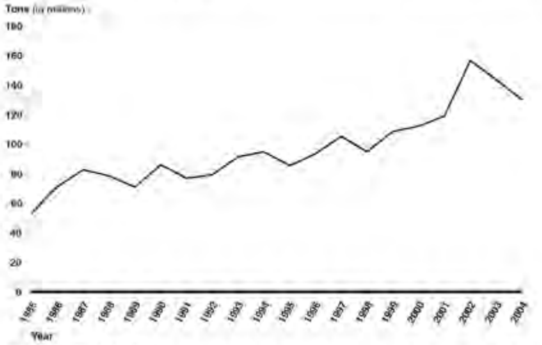
Figure 15: Percentage of Industry Tonnage and Revenue Generated from Traffic Traveling at Rates Equal to or Greater Than 180 Percent R/VC, 1985-2004



Source: GAO analysis of STB data.

However, since 1985, tonnage from traffic traveling at rates substantially over the threshold for rate relief has increased. Total industry tonnage has increased significantly (from 1.37 billion tons in 1985 to 2.14 billion tons in 2004), with the tonnage traveling at rates above 300 percent R/VC more than doubling—from about 53 million tons in 1985 to over 130 million tons in 2004 (see fig. 16).

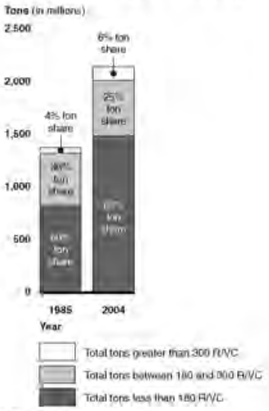
Figure 16: Tonnage Traveling at Rates over 300 Percent R/VC, 1985-2004



Source: GAO analysis of STB data.

As a percentage of all industry traffic, traffic traveling at rates between 180 and 300 percent R/VC decreased from 36 percent in 1985 to 25 percent in 2004. In contrast, the percentage of all industry traffic traveling at rates above 300 percent R/VC increased from 4 percent in 1985 to 6 percent in 2004 (see fig. 17).

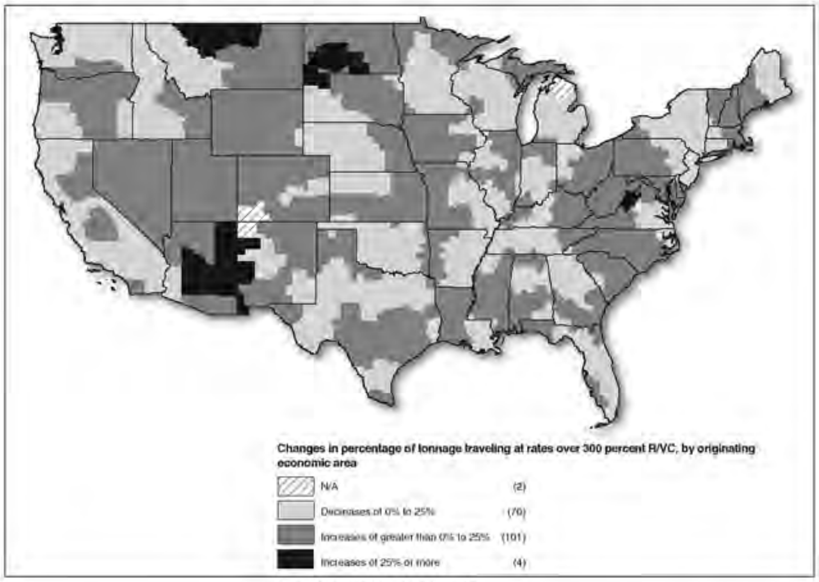
Figure 17: Percentage of Tonnage by R/VC, 1985 and 2004



Source: GAO analysis of STB data.

Increases in traffic traveling at rates over 300 percent R/VC appear widely distributed throughout the country, although in some areas increases have been higher than in others. Four economic areas located in parts of Montana, New Mexico, North Dakota, and West Virginia had the largest increases in traffic traveling at rates over 300 percent R/VC, with an increase of more than 25 percent from 1985 through 2004 (see fig. 18).

Figure 18: Changes in Percentage of Tonnage Traveling at Rates over 300 Percent R/VC, by Originating Economic Area, 1985 through 2004

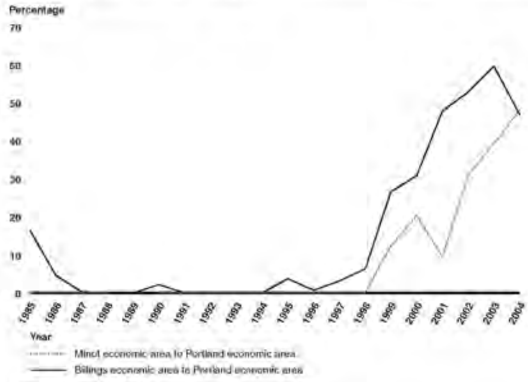

Changes in percentage of tonnage traveling at rates over 300 percent R/VC, by originating economic area
N/A (2)
Decreases of 0% to 25% (76)
Increases of greater than 0% to 25% (101)
Increases of 25% or more (4)

Source: GAO analysis of BEA, DOT, and STB data.

In addition to national changes, significant increases in traffic traveling at rates over 300 percent R/VC can be seen in certain states, for certain commodities, and for certain routes. For example, in 1985 virtually no coal originating in Ohio traveled at rates over 300 percent R/VC. In 2004, nearly half of coal traffic originating in Ohio traveled at rates over 300 percent R/VC. Increases in traffic traveling at rates over 300 percent R/VC can also be seen at the route level. Figure 19 shows the amount of traffic traveling at rates over 300 percent R/VC on long-distance grain routes from the Minot, North Dakota, and Billings, Montana, economic areas to the

Portland-Vancouver-Beaver Falls, Oregon, economic area. Of the routes we examined, these two had the highest percentage of traffic traveling at rates over 300 percent R/VC for 2004, and on both routes, this traffic had substantially increased over 1985 levels.[27]

Figure 19: Long-distance Grain Route Changes in Percentage of Tonnage Traveling at Rates over 300 Percent R/VC, 1985-2004



Source: GAO analysis of STB data.

For both the Minot and Billings routes, increases in R/VC from 1985 through 2004 were driven more by increases in revenue than by changes in variable cost. From 1985 through 2004, revenue from all grain traffic—not just traffic traveling at rates above the statutory threshold for rate relief—on the Minot, North Dakota, to the Portland-Vancouver-Beaver Falls, Oregon, economic area increased from approximately $18.4 million to approximately $30.8 million. Variable cost increased at a much slower pace, rising from approximately $12.2 million to approximately $12.4 million. For the route from the Billings, Montana, economic area to the Portland-Vancouver-Beaver Falls, Oregon, economic area, grain revenue more than tripled, from approximately $11.2 million in 1985 to approximately $42.7 million in 2004. Variable cost also increased substantially—although still not as much as revenue—rising from approximately $5.5 million to approximately $15.1 million.

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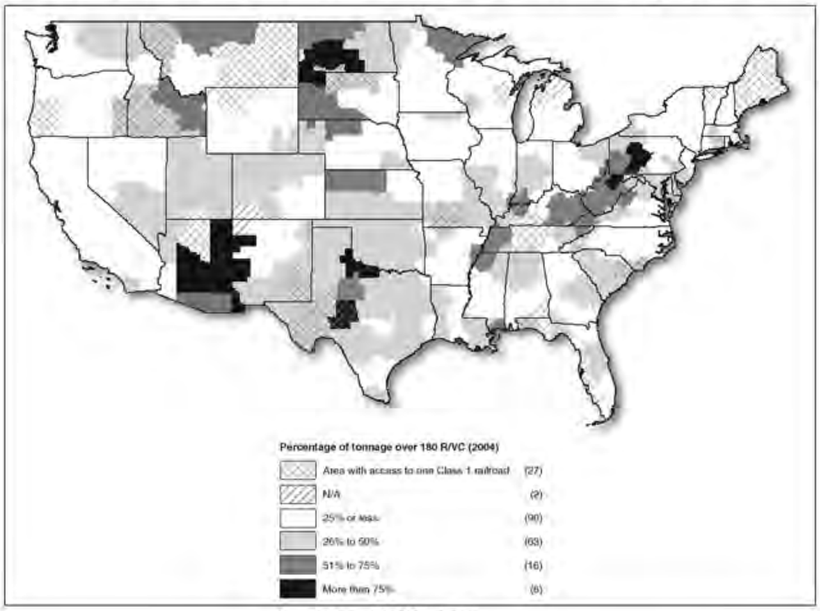
[27] By contrast, the long-distance grain route shown in figure 9 (from the Sioux Falls, South Dakota, economic area to the Portland, Oregon, economic area) had no traffic traveling at rates over 300 percent R/VC for 2004.

Some Areas with Access to One Railroad Have Higher Percentages of Traffic Traveling at Rates That Exceed the Threshold for Rate Relief

Some economic areas with access to one Class I railroad also have more than half of their traffic traveling at rates that exceed the statutory threshold for rate relief. For example, parts of New Mexico and Idaho with access to one Class I railroad have more than half of all traffic originating in those same areas traveling at rates over 180 percent R/VC (see fig. 20). However, there are instances in which an economic area may have access to two or more Class I railroads and still have more than 75 percent of its traffic traveling at rates over 180 percent R/VC, as well as other instances in which an economic area may have access to one Class I railroad and have less than 25 percent of its traffic traveling at rates over 180 percent R/VC. Yet there are parts of the country with access to one Class I railroad that also have higher percentages of traffic traveling at rates over the statutory threshold for rate relief.

Figure 20: Overlap between Percentage of Tonnage over Threshold for Rate Relief and Access to Only One Class I Railroad


Percentage of tonnage over 180 R/VC (2004)
Area with access to one Class 1 railroad (27)
N/A (2)
25% or less (90)
26% to 50% (63)
51% to 75% (16)
More than 75% (6)

Source: GAO analysis of BEA, DOT, and STB data.

Our analysis shows that some areas of the country with access to only one Class I railroad have higher levels of traffic traveling at rates over the statutory threshold for rate relief. This situation may reflect reasonable economic practices by railroads in an environment of excess demand, or it may represent an abuse of market power. Our analysis provides an important first step in assessing competitive markets nationally, but it is imperfect given the inherent limitations of the *Carload Waybill Sample* and of the proxy measures available for weighing captivity. When combined with comments from participants on our expert panel and interviews with shipper and railroad groups, the results of our analysis suggest that shippers in selected markets may be paying excessive rates, meriting further inquiry and analysis.

Despite STB's Actions, Analysis of Competitive Markets Is Needed to Address Lack of Effective Relief for Captive Shippers

The Staggers Rail and ICC Termination Acts promoted greater reliance on competition as the preferred method to protect shippers from unreasonable rates and granted STB broad authority to monitor the performance of the railroad industry. STB has taken a number of actions to provide protections for captive shippers from unreasonable rates in the absence of effective competition, including establishing a process for captive shippers to obtain relief from unreasonable rates. Despite STB's actions, there is little effective relief for captive shippers because STB's standard rate relief process is largely inaccessible. While STB continues to refine its practices, an assessment of competitive markets would provide further information about the extent of captivity among shippers and the merits of a range of proposed actions to enhance competitive options available to shippers. In addition, changes to the rate relief process could provide greater protection from unreasonable rates.

STB Has Broad Authority to Monitor the Railroad Industry

The Staggers Rail and ICC Termination Acts encourage competition as the preferred way to protect shippers and to promote the financial health of the railroad industry. At the same time, the acts give STB the authority to

- *adjudicate rate cases* to resolve disputes between captive shippers and railroads upon receiving a complaint from a shipper;
- *approve rail transactions*, such as mergers, consolidations, acquisitions, and trackage rights;
- *prescribe new regulations*, such as rules for competitive access and merger approvals; and
- *inquire into and report on rail industry practices*, including obtaining information from railroads on its own initiative and holding hearings to inquire into areas of concern, such as competition.

The federal courts have upheld STB's general powers to monitor the rail industry, including its ability to subpoena witnesses and records and depose witnesses.

STB has the authority and ability to inquire into and report on railroad practices, and it also has authority to take a number of actions based on the results of that inquiry. First, STB could issue a general rule making that would alter the administrative rules for the industry. For example, STB has the authority to require a railroad to make their terminal facilities available to another railroad under certain circumstances. Second, STB could reopen a past decision if it found a material error in the case, new evidence emerged, or circumstances affecting the case substantially changed. Finally, if STB received a complaint from a shipper, it could then launch a formal investigation and prescribe specific remedies to address the complaint.

STB Has Taken Actions to Protect Captive Shippers

Under its adjudicatory authority, STB has taken a number of actions to provide protection for captive shippers. STB determines the reasonableness of challenged rates in the absence of competition upon receiving a complaint from a shipper. The rate relief process is the principal method by which shippers seek relief from unreasonable rates. STB developed standard rate case guidelines, under which captive shippers can challenge a rail rate and appeal to STB for rate relief. Under the standard rate relief process, STB assesses whether the railroad dominates the shipper's transportation market and, if it finds market dominance, proceeds with further assessments to determine whether the actual rate the railroad charges the shipper is reasonable. STB requires that the shipper demonstrate how much an optimally efficient railroad would need to charge the shipper and construct a hypothetical, perfectly efficient railroad that would replace the shipper's current carrier. As part of the rate relief process, both the railroad and the shipper have the opportunity to present their facts and views to STB, as well as to present new evidence. In 1999,[28] we reported that shippers and shippers' associations indicated that constructing a hypothetical railroad is difficult, particularly for small shippers, because the time and cost associated with the model's development may outweigh the compensation afforded the shipper should STB determine that the challenged rate was unreasonable. Since we reported on the process in 1999, STB has taken several actions to reduce potential barriers for filing a complaint. For example, STB now conducts mediation to begin cases, has added staff to process cases, and has eliminated certain criteria for assessing whether a railroad dominates a shipper's market.[29]

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[28] GAO, *Railroad Regulation: Current Issues Associated with the Rate Relief Process*, GAO/RCED-99-46 (Washington, D.C.: Feb. 26, 1999).

STB also created alternatives to the standard rate relief process, developing simplified guidelines, as Congress required, for cases in which the standard rate guidelines would be too costly or infeasible given the value of the cases. Under these simplified guidelines, captive shippers who believe that their rate is unreasonable can appeal to STB for rate relief, even if the value of the disputed traffic makes it too costly or infeasible to apply the standard guidelines. In addition, STB created a voluntary arbitration option that parties can use to resolve disputes over rates.

Under its authority to approve rail transactions, STB has approved railroad mergers that it finds consistent with the public interest. STB has also taken action to ensure that any potential merger-related harm to competition is mitigated. STB's mitigation efforts have focused on preserving competition where it could be lost at 2-to-1 points,[30] for example, by imposing conditions that allow one railroad to operate over the tracks of another railroad (called trackage rights). STB has historically not taken action to introduce service where shippers have service by only one carrier.

Under its authority to prescribe new regulations, STB established a process by which shippers can file a complaint if they are captive to one railroad and believe that the railroad is engaged in anticompetitive behavior. Under this process, if the shipper proves that the railroad is engaged in anticompetitive behavior, STB can prescribe remedies such as trackage rights that would give the shipper access to another railroad.

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[29] In December 1998 and July 1999, STB excluded product and geographic competition as factors to be considered in market dominance proceedings, finding that the applicable law did not require consideration of those factors; that consideration of those factors unduly burdened shippers attempting to bring rate cases; and that the exclusion of those factors would not have any substantial effect on the rates that the railroads could charge in the marketplace (See Surface Transportation Board "News" releases Nos. 99-32, issued on Jul. 2, 1999, and 98-82, issued on Dec. 21, 1998). The railroad industry sought judicial review of the Board's decisions, and in *Association of Am. Railroads v. STB, 237 F.3d 676* (D.C. Cir. 2001), the United States Court of Appeals for the District of Columbia Circuit (Court) remanded (returned) the matter for the Board's further consideration. On remand, STB provided additional analysis to support its earlier decision, and the court then affirmed (upheld) STB's action, in *Association of Am. Railroads v. STB, 306 F.3d 1108* (D.C. Cir. 2002).

[30] 2-to-1 points are where shippers currently have access to two carriers but could lose access to one of them through a merger or acquisition.

Finally, under its authority to inquire into and report on the rail industry, STB instituted proceedings to review rail access and competition issues. For example, in April 1998, at the request of Congress, STB commenced a review of access and competitive service in the rail industry. In April 1998, STB decided to consider revising its competitive access rules. However, in its December 1998 report to Congress, STB declined to take further action on this issue because it had adopted new rules giving shippers temporary access to alternative routing options during periods of poor service. In addition, STB observed that the competitive access issue raises basic policy questions that are more appropriately resolved by Congress. In 2001, STB adopted new regulations for rail mergers that require the applicant to demonstrate that the merger would enhance, not just preserve, competition.

Efforts Have Led to Little Effective Relief

Despite STB's efforts, there is widespread agreement that STB's standard rate relief process is inaccessible to most shippers and does not provide for expeditious handling and resolution of complaints. The process remains expensive, time consuming, and complex. While STB does not keep records of the cost of a rate case, shippers we interviewed agreed that the process can cost approximately $3 million per litigant. Shippers told us that, to initiate a case, the case would need to involve several million dollars so that it would be worthwhile to spend $3 million on a case that they could possibly lose. Thus, shippers noted that only large-volume shippers, such as coal shippers, with set origins and destinations have the money to be able to afford the STB rate relief process. In addition, shippers said that they do not use the process because it takes so long for STB to reach a decision. Lastly, shippers continue to state that the process is both time consuming and difficult because it calls for them to develop a hypothetical competing railroad to show what the rate should be and to demonstrate that the existing rate is unreasonable. Since 2001, only 10 cases have been filed, and these cases took between 2.6 and 3.6 years—an average of 3.3 years per case—to complete. Of those 10 cases, 9 were filed by coal shippers.

The simplified guidelines also have not effectively provided relief for captive shippers. Although these simplified guidelines have been in place since 1997, a rate case has not been decided under the process set out by the guidelines. STB held public hearings in April 2003 and July 2004 to examine why shippers have not used the guidelines and to explore ways to improve them. At these hearings, numerous organizations provided comments to STB on measures that could clarify the simplified guidelines, but no action was taken. STB observed that parties urged changes to make the process more workable, but disagreed on what those changes should be. Several shipper organizations told us that shippers are concerned about using the simplified guidelines because they believe the guidelines will be challenged in court, resulting in lengthy litigation. STB officials told us that they—not the shippers—would be responsible for defending the guidelines in court. STB officials also said that if a shipper won a small rate case, STB could order reparations to the shipper before the case was appealed to the courts.

STB's arbitration option has never been used. Under this approach, an arbitrator would decide the rate, using a "give and take" approach—that is, the arbitrator would determine the rate without being required to pick one of the two offers. According to STB officials, this option has not been used, in part, because the cases that go before STB are contentious, with high monetary stakes. As a result, there is less willingness from either side to arbitrate.

Shippers have not obtained relief through STB's "competitive access" rules. Under these rules, shippers can file a complaint to request that one railroad obtain access to another railroad's tracks when necessary to remedy anticompetitive behavior by the owning railroad. Shippers who file a complaint must show that the owning railroad has engaged in anticompetitive behavior. To date, STB has found that all complaints have failed to prove that the owning railroad has engaged in anticompetitive behavior.

STB Continues to Refine the Process

During our review, STB has continued to refine its processes for shippers to obtain relief from unreasonable rates and competitive access. For example, STB recently proposed a rule making to make changes to the simplified guidelines in order to respond to comments gathered at the STB hearings held in April 2003 and July 2004 to examine why those guidelines have not been used by shippers and to explore ways to improve the guidelines. In addition, STB is seeking public comment on several measures it has proposed to adopt regarding railroad practices involving fuel surcharges. The proposals follow STB's May 2006 public hearing on how railroads calculate and charge fuel surcharges and respond to extensive testimony on these charges submitted to STB by the rail industry, the public, and railroad customers. STB announced its intent to hold a public hearing on certain issues related to rail transportation rates for grain. Lastly, STB recently requested written comments and held a public hearing in response to a petition filed by a shipper group to prevent, or put a time limit on, paper barriers, which are contractual agreements that may be made when a Class I railroad either sells or leases some of its track to another railroad (typically a short line railroad or regional railroad), but stipulates that virtually all traffic that originates on that line must interchange with the Class I railroad that sold the tracks or pay a penalty.

Assessment of Competitive Markets and Changes to Rate Relief Process Could Provide More Relief

The results of our analysis suggest a reasonable possibility that shippers in selected markets may be paying excessive rates related to a lack of competition in these markets. While our analysis of available measures shows that the extent of captivity appears to be dropping in the freight railroad industry, shippers that may be captive are paying substantially over the statutory threshold for initiating a rate relief case. This situation may simply reflect reasonable economic practices by railroads in an increasingly constrained environment in which demand for rail services increasingly exceeds supply, or it may represent an abuse of market power. Our analysis provides an important first step in assessing competitive markets nationally, but it is imperfect given the inherent limitations of the *Carload Waybill Sample* and the proxy measures available for weighing captivity. A more rigorous analysis of competitive markets nationally is needed—one that identifies the state of competition nationwide and inquires into pricing practices in specific markets. If this assessment determines that market power is being abused or the goals of the Staggers Rail Act are not being met, STB could consider several methods to ease competition concerns, such as initiating a generally applicable rule making; or, if a complaint is filed, providing specific remedies to increase competition.

Shipper groups, economists, and other experts in the rail industry have suggested several alternative approaches as remedies that could provide more competitive options to shippers in areas of inadequate competition or excessive market power. These groups view these approaches as more effective than the rate relief process in promoting a greater reliance on competition to protect shippers against unreasonable rates. Some proposals would require legislative change, or a reopening of past STB decisions.[31]

These approaches each have potential costs and benefits. On the one hand, they could expand competitive options, reduce rail rates, and decrease the number of captive shippers as well as reduce the need for both federal regulation and a rate relief process. On the other hand, reductions in rail rates could affect railroad revenues and limit the railroads' ability and potential willingness to invest in their infrastructure. In addition, some markets may not have the level of demand needed to support competition among railroads. However, in markets that do, the targeted approaches frequently proposed by shipper groups and others include the following:

- *Reciprocal switching:* This approach would allow STB to require railroads serving shippers that are close to another railroad to transport cars of a competing railroad for a fee. The shippers would then have access to railroads that do not reach their facilities. This approach is similar to the mandatory interswitching in Canada, which enables a shipper to request a second railroad's service if that second railroad is within approximately 18 miles. Some Class I railroads already interchange traffic using these agreements, but they oppose being required to do so. Under this approach, STB would oversee the pricing of switching agreements. This approach could also reduce the number of captive shippers by providing a competitive option to shippers with access to a proximate but previously inaccessible railroad and thereby reduce traffic eligible for the rate relief process (see fig. 21).

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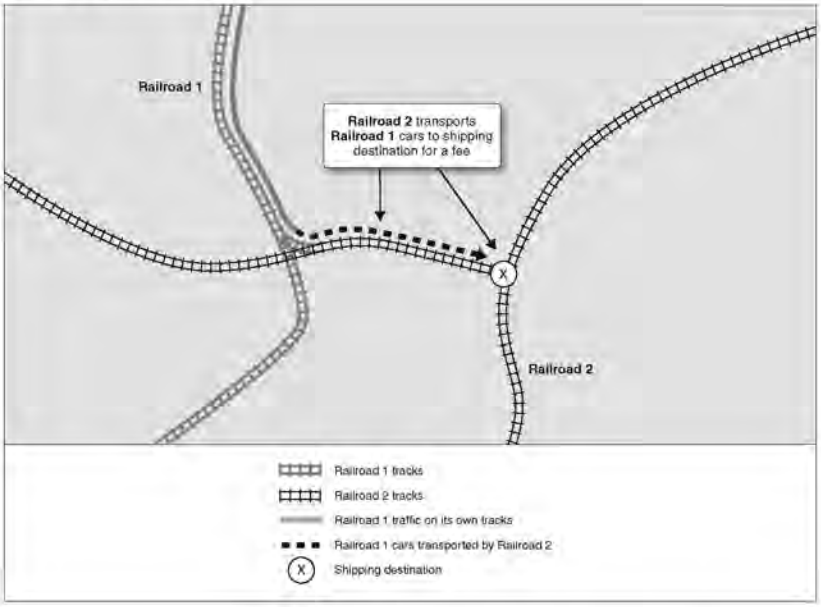
[31] Another proposal, articulated by economists Curtis Grimm and Cliff Winston, calls for the elimination of STB. This proposal recognizes that captive shippers have likely been hurt by a lack of competition, but it states that allowing the Department of Justice to review rail mergers instead of STB and ending the potential for reregulation of the industry could lead railroad officials and shippers to negotiate an agreement to address remaining rail competition concerns. Curtis Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry: Sources, Effects, and Policy Issues," (AEI – Brooking Institution. Washington, D.C.: 2000).

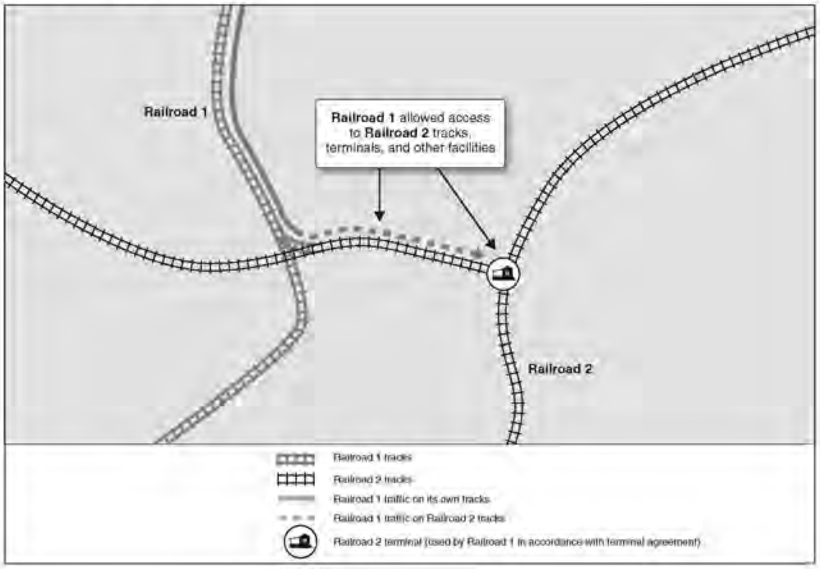
Figure 21: Reciprocal Switching


Railroad 1
Railroad 2 transports Railroad 1 cars to shipping destination for a fee
X
Railroad 2
Railroad 1 tracks
Railroad 2 tracks
Railroad 1 traffic on its own tracks
Railroad 1 cars transported by Railroad 2
Shipping destination

Source: GAO

- *Terminal agreements:* This approach would require one railroad to grant access to its terminal facilities or tracks to another railroad, enabling both railroads to interchange traffic or gain access to traffic coming from shippers off the other railroad's lines for a fee. Current regulation requires a shipper to demonstrate anticompetitive conduct by a railroad before STB will grant access to a terminal by a nonowning railroad unless there is an emergency or when a shipper can demonstrate poor service and a second railroad is willing and able to provide the service requested. This approach would require revisiting the current requirement that railroads or shippers demonstrate anticompetitive conduct in making a case to gain access to a railroad terminal in areas where there is inadequate competition. The approach would also make it easier for competing railroads to gain access to the terminal areas of other railroads and could increase competition between railroads. However, it could also reduce revenues to all railroads involved and adversely affect the financial condition of the rail industry. Also, shippers could benefit from increased competition but might see service decline (see fig. 22).

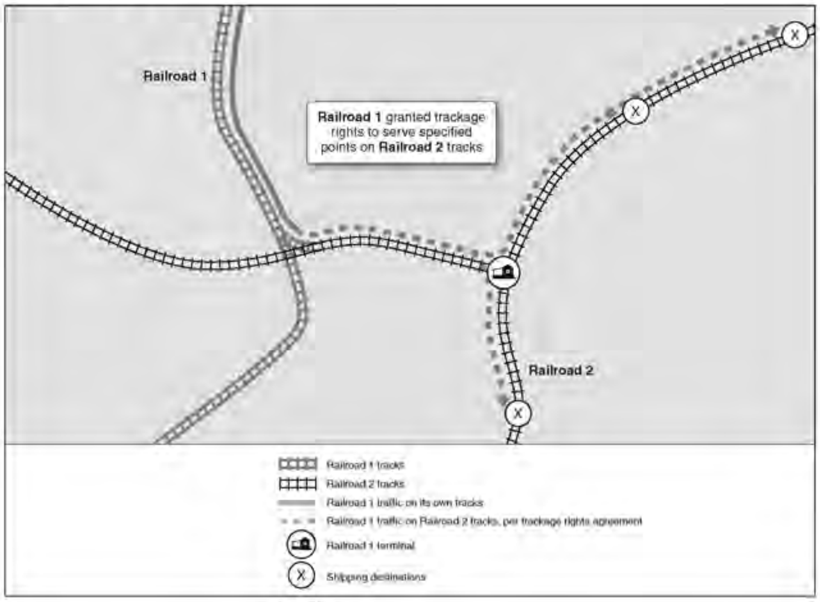
Figure 22: Terminal Agreements


Railroad 1
Railroad 1 allowed access to **Railroad 2** tracks, terminals, and other facilities
Railroad 2
Railroad 1 tracks
Railroad 2 tracks
Railroad 1 traffic on its own tracks
Railroad 1 traffic on Railroad 2 tracks
Railroad 2 terminal (used by Railroad 1 in accordance with terminal agreement)

Source: GAO.

- *Trackage rights:* This approach would require one railroad to grant access to its tracks to another railroad, enabling railroads to interchange traffic beyond terminal facilities for a fee. In the past, STB has imposed conditions requiring that a merging railroad must grant another railroad trackage rights to preserve competition when a merger would reduce a shipper's access to railroads from two to one. While this approach could potentially increase rail competition and decrease rail rates, it could also discourage owning railroads from maintaining the track or providing high-quality service, since the value of lost use of track may not be compensated by the user fee and may decrease return on investment (see fig. 23).

Figure 23: Trackage Rights


Railroad 1
Railroad 1 granted trackage rights to serve specified points on Railroad 2 tracks
Railroad 2
X
Railroad 1 tracks
Railroad 2 tracks
Railroad 1 traffic on its own tracks
Railroad 1 traffic on Railroad 2 tracks, per trackage rights agreement
Railroad 1 terminal
Shipping destinations

Source: GAO.

"Bottleneck" rates: This approach would require a railroad to establish a rate, and thereby offer to provide service, for any two points on the railroad's system where traffic originates, terminates, or can be interchanged. Some shippers have more than one railroad that serves them at their origin and/or destination points, but have at least one portion of a

rail movement for which no alternative rail route is available. This portion is referred to as the "bottleneck segment." STB's decision that a railroad is not required to quote a rate for the bottleneck segment has been upheld in federal court.[32] STB's rationale was that statute and case law precluded it from requiring a railroad to provide service on a portion of its route when the railroad serves both the origin and destination points and provides a rate for such movement. STB requires a railroad to provide service for the bottleneck segment only if the shipper had prior arrangements or a contract for the remaining portion of the shipment route. On the one hand, requiring railroads to establish bottleneck rates would force short-distance routes on railroads when they served an entire route and could result in loss of business and potentially subject the bottleneck segment to a rate complaint. On the other hand, this approach would give shippers access to a second railroad, even if a single railroad was the only railroad that served the shipper at its origin and/or destination points, and could potentially reduce rates (see fig. 24).

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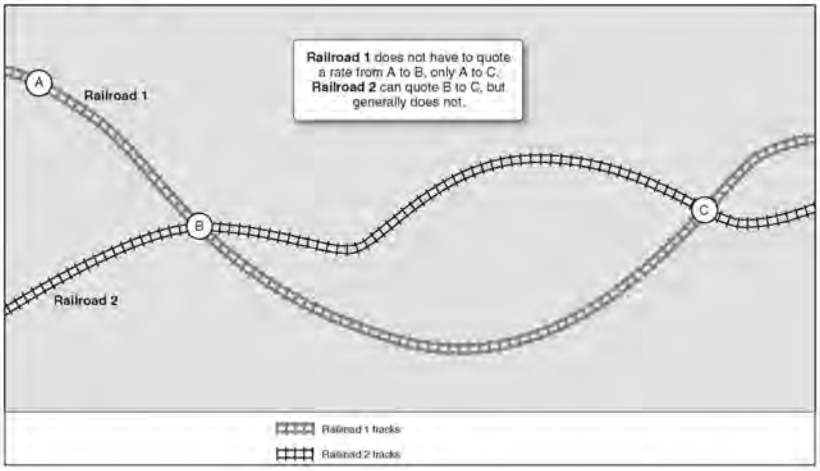
[32] The U.S. Court of Appeals for the Eighth Circuit affirmed STB decision that a bottleneck carrier generally need not quote a separate rate for the bottleneck portion of the route. *Mid-American Energy Co. v. Surface Transportation Board*, 169 F. 3d 1099 (8th Cir.: Feb. 10, 1999). The D.C. Circuit affirmed STB holding that separately challengeable bottleneck rates can be required whenever a shipper has a contract over the nonbottleneck segment of a through movement. *Union Pacific Railroad v. Surface Transportation Board*, 202 F. 3d 337 (D.C. Cir.: 2000).

Figure 24: Bottleneck Rates



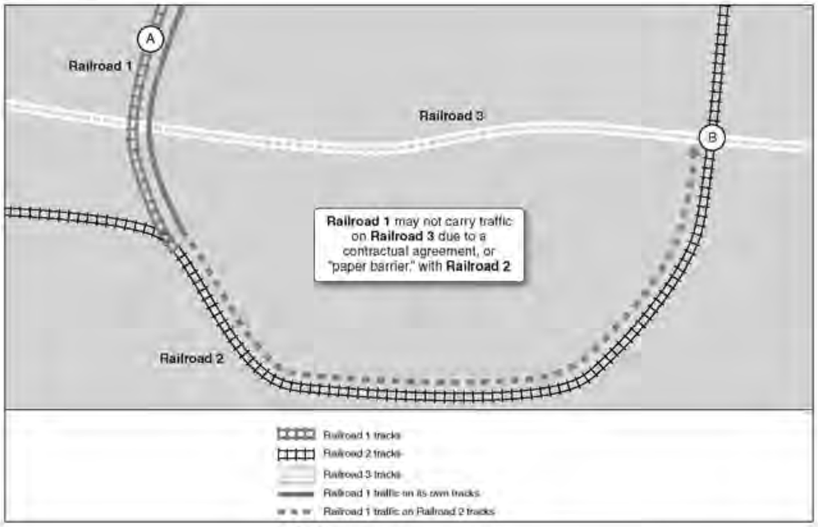
Railroad 1 does not have to quote a rate from A to B, only A to C. **Railroad 2** can quote B to C, but generally does not.

Source: GAO.

Paper barriers: This approach would prevent or, put a time limit on, paper barriers, which are contractual agreements that can occur when a Class I railroad either sells or leases long term some of its track to other railroads (typically a short-line railroad and/or regional railroad). These agreements stipulate that virtually all traffic that originates on that line must interchange with the Class I railroad that originally leased the tracks or pay a penalty. Since the 1980s, approximately 500 short lines have been created by Class I railroads selling a portion of their lines; however, the extent to which paper barriers are a standard practice is unknown because they are part of confidential contracts. When this type of agreement exists, it can inhibit smaller railroads that connect with or cross two or more Class I rail systems from providing rail customers access to competitive service. Eliminating paper barriers could affect the railroad industry's overall capacity since Class I railroads may abandon lines instead of selling them to smaller railroads and thereby increase the cost of entering.

a market for a would-be competitor. In addition, an official from a railroad association told us that it is unclear if a federal agency could invalidate privately negotiated contracts (see fig. 25).

Figure 25: Paper Barriers


A
Railroad 1
Railroad 3
B
Railroad 1 may not carry traffic on Railroad 3 due to a contractual agreement, or "paper barrier," with Railroad 2
Railroad 2
Railroad 1 tracks
Railroad 2 tracks
Railroad 3 tracks
Railroad 1 traffic on its own tracks
Railroad 1 traffic on Railroad 2 tracks

Source: GAO

It will be important for policymakers, in evaluating these alternative approaches, to carefully consider the impact of each approach on the balance set out in the Staggers Rail Act. One significant consideration is the revenue adequacy of the railroads. The Staggers Rail Act established revenue adequacy as a goal for the industry and allowed the railroads to use differential pricing to increase their revenues. While the specific method for determining revenue adequacy has been controversial, the overall trend in revenue adequacy may be more important. In its last report for 2004, STB determined that one railroad is revenue adequate and that others are approaching revenue adequacy. It is too early to determine that the industry as a whole is achieving revenue adequacy. Nevertheless, this improvement in the railroads' financial condition represents a significant shift in the rail industry because for decades after the enactment of the Staggers Rail Act, the railroads were all considered revenue inadequate. The railroads need sufficient revenue for infrastructure investment to keep pace with increased demand. However, each of these changes could decrease the amount of revenue the railroads receive. Yet, as the railroad's revenue adequacy improves, the question arises as to what degree the railroads should continue to rely, for their investment needs, on obtaining significantly higher prices from those with greater reliance on rail transportation.

To prevent problems with unreasonable rates, some shipper groups propose targeted approaches that would provide them with more competitive options. A number of different approaches have also been suggested to make the rate relief process less expensive, more expeditious, and therefore potentially more accessible. Each of the proposed approaches has both advantages and drawbacks. These approaches include the following:

- *Increase the use of simplified guidelines:* The simplified guidelines use standard industry average figures for revenue data instead of requiring the shipper to create a hypothetical railroad. This approach would reduce the time and complexity of the process; however, it may not provide such an accurate and precise a measure as the standard process. Both shippers and railroad officials with whom we spoke agree that it is confusing to determine who is eligible to use the process and how it would work. STB recently issued a proposed rule making to pursue changes to the simplified guidelines to provide captive shippers greater access to regulatory remedies for unreasonable rail rates.
- *Increase the use of arbitration:* Under arbitration, two parties present their case before an arbitrator, who determines the rate. This process replaces the shipper's requirement to create a hypothetical railroad. Proponents of arbitration argue that the threat of arbitration can induce railroads and shippers to resolve their own problems and limit the need for federal regulation. In addition, the process is quicker and cheaper than the standard rate relief process. For example, Canada offers an arbitration process known as Final Offer Arbitration (FOA), under which both parties submit their best and final offers, and the arbitrator considers the argument from both sides and picks one rate offer from either the railroad

or the shipper. FOA is quicker—statutorily, once the process begins it has to be completed within 60 days, or 30 days for disputes involving freight charges of less than $750,000, unless the parties agree to a different time frame. In addition, FOA is cheaper—estimates ranged up to $1 million Canadian dollars, for both parties. On the other hand, the decisions are good for only 1 year, so the process could in theory be revisited annually. Critics of this approach suggest that arbitration decisions may not be based on economic principles, such as the revenue and cost structure of the railroad, and arbitrators may not be knowledgeable about the railroad industry. Furthermore, opinions differ significantly about which types of disputes should be covered and what standards (if any) should apply.

- *Develop an alternative cost methodology:* STB could develop an alternative to the cost methodology used under the standard process in which a shipper must demonstrate how much an optimally efficient railroad would need to charge a shipper by constructing a hypothetical, perfectly efficient railroad that would replace its current carrier. For example, STB could use a long-run incremental cost approach to evaluate and decide rate cases. This process, which is used by the Federal Energy Regulatory Commission for regulating rates charged by pipeline companies, bases rates on the actual incremental cost of moving a particular shipment, plus a reasonable rate of return. This approach allows for a quick, standard method for setting prices, but does not take into account the need for differential pricing or the railroad's need to charge higher rates in order to become revenue adequate. Structuring rate regulation around actual costs can also create potential disincentives for the regulated entity to control its costs.

Uncertainty about Future Freight Rail Demand and Capacity Points to Opportunities for a More Strategic Federal Approach to Rail Infrastructure

Recent forecasts predict that the demand for freight and freight rail transport will grow significantly in the future. While forecasts have limitations as guides to investing in new transportation infrastructure, they can present a plausible picture of future freight demand and capacity. Whether private rail companies will be able and willing to invest in new infrastructure capacity to meet projected future demand is uncertain. New rail capacity not only benefits each private rail company network, but it also has the potential to benefit the public by improving traffic flow, air quality, and safety at the national, state, and local levels. As a result, the public sector has increasingly been investing in freight rail projects. Federal involvement in the freight system should be consistent with the competitive marketplace and ensure that funding decisions reflect widespread public priorities.

Forecasts of Significant Freight Rail Traffic Growth Provide a Plausible Outlook for the Future

The demand for freight transportation in general and freight rail specifically is forecasted to increase, according to recent studies.[33] Several of these studies also quantify their projections of the volume and value of future freight demand. The Freight Analysis Framework (FAF) is a comprehensive database and policy analysis tool maintained by DOT to help identify needed freight capacity improvements. In 2002, DOT projected, using this tool, that overall domestic and international freight demand would increase by more than 65 percent and 84 percent, respectively, by 2020. In 2003, the American Association of State Highway and Transportation Officials (AASHTO) released the *Freight Rail Bottom Line Report*, prepared by a consulting firm. This report describes the industry and its benefits to the nation, estimates the industry's investment needs and capacity to meet these needs, and quantifies the consequences of underinvestment, including highway deterioration and congestion. The AASHTO study projected that, by 2020, overall domestic freight demand by ton would increase by 57 percent and international demand would increase by 99 percent. In 2005, the American Trucking Association's (ATA) report *U.S. Freight Transportation Forecast to 2016* projected tonnage and revenues for all freight modes. The report predicted that overall freight volume would increase by about 32 percent between 2004 and 2016.

Freight rail demand is projected to increase less than overall freight demand and to grow at a slower rate than demand for other modes—such as truck and air freight. FAF projects that freight rail tonnage will grow about 55 percent by 2020, but this growth will not be as dramatic as for truck and air, and will account for a much smaller share of the market when measured on the basis of shipment value. AASHTO predicts that freight rail tonnage will increase 44 percent by 2020. However, it notes that this forecast actually indicates that rail will lose some market share. This estimate also assumes that considerable investment will be required—up to about $4 billion annually—to meet future demand. According to ATA's forecast, freight rail tonnage will grow annually by 2.4 percent to 2010 and by 2.1 percent to 2016. While rail intermodal traffic is forecast to grow rapidly, the study anticipates that rail's overall share of total freight tonnage will decrease slightly from about 15.6 percent in 2004 to about 15.4 percent in 2016.

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[33] Studies by the AASHTO, DOT, and American Trucking Association made specific freight and freight rail forecasts. Studies by the Transportation Research Board (TRB), the National Cooperative Research Program (NCHRP 20-24(33)) administered by TRB, and a consortium of Midwestern states and universities (Upper Midwest Freight Corridor Study) also assessed future freight demand and capacity issues.

However, ow many factors can affect the accuracy of these predictions. Freight markets are volatile and unpredictable, and thus freight demand forecasts may prove to be off the mark. Similarly, much freight traffic is determined by trade that originates outside the United States. Moreover, since the data and models used to develop these freight demand forecasts are largely proprietary,[34] we could not assess the validity or reasonableness of the assumptions used to develop the predictions.[35] Nevertheless, forecasts of freight and freight rail demand are useful as one plausible scenario for the future. As the Congressional Budget Office (CBO) observed in a January 2006 report, forecasts of demand are best viewed as illustrative rather than quantitatively accurate.[36]

Railroads' Investments in Capacity to Meet Potential Demand Are Uncertain

If demand does develop as forecasted, it is uncertain how able and willing railroads will be to invest in new capacity. Railroads do not prepare long-term capacity plans because of concern about the potential for significant economic changes—for example, officials at one Class I railroad stated that they prepare capacity improvements plans and demand projections for 3 to 5 years into the future, with frequent revisions. In addition, the railroads we interviewed were generally unwilling to discuss their future investment plans with us in any detail because this is business proprietary information. It is therefore difficult to comment on how railroads are likely to choose among their competing investment priorities for the future compared with various demand scenarios.

Railroads' ability and willingness to invest in new capacity to meet demand reflects a number of key considerations. For privately owned rail companies, a key business consideration is maximizing returns for shareholders. To do so, realizing the greatest return on investment from each investment decision is essential and is reinforced by pressure from shareholders. Rail investment involves private companies taking a substantial risk which becomes a fixed cost on their balance sheets, one on which they are accountable to stockholders and for which they must make capital charges year in and year out for the life of the investment. A railroad contemplating such an investment must be confident that the market demand for that infrastructure will hold up for 30 to 50 years. This is in sharp contrast to other modes such as highway infrastructure, which is paid for largely by public funds. Maximizing a rail company's competitive position in key markets is important in deciding on investments in the company network's size and facilities. For example, the growth of intermodal transport is a major development for freight rail because it stands to be the largest revenue generator for the Class I railroads. As a result, there is intense competition for this business, although intermodal business also means that freight rail both competes and cooperates with other freight modes. However, intermodal growth depends on the railroads' ability to invest in the new capacity needed to meet this demand.

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[34] The 2002 FAF used proprietary models to describe domestic and international commodity flows for rail, water, air, and highways and forecasted freight flows for 2010 and 2020. A second generation DOT FAF (being published in 2006) does not use proprietary models and covers commodity flows for 2002 to 2035.

[35] We were able to interview some of the consultants who authored these reports and other rail experts. We also independently corroborated information in these reports through our expert panel.

[36] Congressional Budget Office, *Freight Rail Transportation: Long Term Issues* (Washington, D.C.: January 2006).

Investment considerations are complicated by the current status of rail infrastructure. Although the rail network has been downsized, the infrastructure remains extensive but aging. Replacing, maintaining, and upgrading this infrastructure is extremely costly, as the Transportation Research Board emphasized in its analysis of critical transportation issues.[37] Predicting the extent to which future rail investments will keep pace with projected freight rail demand is complicated by the extent of current rail needs. For example, an annual assessment of America's infrastructure[38] conducted by the American Society of Civil Engineering gave rail infrastructure a "C-" grade and noted that, for the first time in 90 years, limited capacity has created significant bottlenecks in the national rail network. However, railroads must invest in new infrastructure, new equipment, and substantial new capacity to handle additional traffic in order to remain viable and effective, a rail industry representative told our expert panel.

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[37] Transportation Research Board, *Critical Issues in Transportation* (Washington, D.C.: Jan. 2006).

[38] American Society of Civil Engineering, *2005 Report Card for America's Infrastructure* (Washington, D.C.: 2005).

Today, freight railroads are sufficiently profitable to be investing at record levels. Major freight railroads have reported[30] that they expect to invest about $8 billion in infrastructure during 2006—a 21 percent increase over 2005—and have told us that they plan to continue making infrastructure investments. However, not all of this investment is planned for capital or new capacity. Although we requested additional detail about how the rail industry's $8 billion estimated investment was divided between new capacity and maintenance or renewal of existing capacity, the Association of American Railroads indicated that this information is not currently available but will be part of a special study on railroad spending trends.

Rail Capacity Investments Can Produce Private and Public Sector Benefits

While private rail networks obtain benefits and improve their profitability from investments in their capacity, these investments also can benefit the public. In fact, some public benefits can be large in comparison to anticipated benefits to the private rail network, as the CBO report pointed out. For example, shifting truck freight traffic to railroads can reduce highway congestion for passenger and commercial vehicles, potentially reducing or avoiding public expenditures that otherwise would be needed to build additional highway capacity or provide additional maintenance to accommodate growing truck traffic. Depending on the rail infrastructure project, the public could realize several types of benefits, as described in table 3.

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[30] Association of American Railroads (AAR), (Washington, D.C.: Mar. 16, 2006).

Table 3: Potential Public Benefits of Rail Transportation Investments

Category	Potential public benefit
Economic	• Lower transportation costs through higher productivity, making it cheaper to produce and distribute goods/services • Improve global competitiveness through increased efficiency • Strengthen local, regional, state economies • Expand industry, employment, tax base
Transportation system	• Capture each mode's advantages in moving passengers/freight • Improve overall system performance • Strengthen intermodal connections • Improve transportation network efficiency for the future • Improve passenger/freight rail interactions
Mobility/Congestion	• Relieve highway congestion by shifting highway freight to rails • Reduce public investment to prevent highway deterioration by preventing diversion of heavy rail freight to roads • Give passengers/freight access to more modes • Decrease travel time, increase reliability
Environmental/Air quality	• Reduce emissions/improve air quality by reducing congestion • Consume about one-fourth to one-third less fuel than trucks
Safety and security	• Reduce crashes through redesigned/eliminated highway-rail crossings • Provide redundant capacity to respond to operational/congestion, national security, and weather problems

Source: GAO analysis.

Rail projects can vary widely in the extent to which they may generate public as well as private benefits; whether benefits are realized by the private or public sector at the national, state, and local levels; and how the benefits are quantified for the purpose of fairly apportioning project financing. Determining what benefits and costs are associated with a rail infrastructure project and who benefits is important in deciding whether public funds for public benefits are justified—but this is a difficult determination.[40] For example, one rail infrastructure project that reduces system bottlenecks may generate benefits to the national economy by lowering the costs of producing and distributing goods. Another rail project that eliminates or improves highway-rail crossings may primarily produce local benefits by reducing accidents, time lost waiting for trains to pass, pollution and noise from idling trains, and delays of emergency vehicles at crossings. The same project also may produce national benefits by reducing the impact of train delays on the system.

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[40] GAO, *Highway and Transit Investments: Options for Improving Information on Projects' Benefits and Costs and Increasing Accountability for Results*, GAO-05-172 (Washington, D.C.: Jan. 24, 2005).

Public Sector's Growing Freight Rail Investments Focus on Securing Public Benefits

Increasingly, governments at all levels have been investing in freight rail improvement projects that offer potential public benefits. At the state and local levels, government involvement has ranged from planning and coordination to collaboration and investment with freight rail companies and other stakeholders. Some states have been investing to help short-line railroads maintain track in their states for almost 20 years. Other states—such as Florida, Virginia, New York, and Pennsylvania—are creating significant new programs to invest in rail projects. Over 30 states have published freight plans that describe their goals and approach to freight and freight rail.

The scope of state and local freight rail investments continues to expand. For example, Missouri state and local governments, in partnership with railroads and other stakeholders, supported two major rail bridge flyover[41] projects to reduce rail delays in Kansas City. These projects—totaling $134 million—were expected to provide economic benefits and reduce rail transit time through the city by about 2 hours. The project also used an innovative institutional arrangement that created a special type of corporation to facilitate its funding. Colorado's Department of Transportation (CDOT), other public entities, and two Class I railroads are exploring an ambitious partnership to relocate freight train facilities away from the heavily populated Front Range area of the state, as the two railroads proposed. CDOT initiated a benefit-cost study[42] that found sufficient public transportation, economic development, land use, safety, environmental, and passenger rail facilitation benefits to warrant investing public dollars in the project—estimated to cost about $1.17 billion.

The federal government also has been involved in freight rail projects. In 1997, DOT provided a $400 million loan for the $2.4 billion Alameda Corridor project to leverage funds from ports, railroads, and local governments. As a result, a 20-mile trench for trains was constructed to eliminate numerous rail-highway crossings and reduce rail transport time to and from the ports of Los Angeles and Long Beach—a significant gateway for freight imported from Asia and distributed throughout the United States. In 2005, Congress provided $100 million to the $1.5 billion Chicago Region Environmental and Transportation Efficiency (CREATE) program. Its objective is to cut train delays and congestion and improve passenger rail service by separating 25 rail-highway crossings, building 6 passenger/freight train flyovers, and upgrading tracks and controls to improve service for the one-third of the nation's rail traffic that comes through Chicago each day. Railroads and state and local governments are contributing to the program's financing. In 2005, Congress also passed the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), which increased the authorized level of funds available under the Railroad Rehabilitation and Improvement Financing (RRIF) program from $3.5 billion to $35 billion over a 5-year period. This program provides loans or loan guarantees that are available to states or railroads for projects to acquire, improve, or rehabilitate rail infrastructure.

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[41] Railroad flyover bridges separate one set of tracks from another—such as freight and passenger trains.

[42] DMJM+Harris and HDR (the Consultant Team), *Final Report Project No. C SWOO-242 Public Benefits & Costs Study of the Proposed BNSF/UP Front Range Railroad Infrastructure Rationalization Project* (May 18, 2005).

A number of proposals before Congress would increase federal funding for freight railroad projects. One proposal calls for the creation of a Railroad Trust Fund that would be similar to the Highway Trust Fund, which is used to pay for highway construction and improvements. Another proposal calls for a railroad investment tax credit. Under this proposal, railroads or shippers would receive a 25 percent tax credit for money spent to expand rail infrastructure.

Federal Response to Freight Investments Should Reflect a National Policy That Is Impartial Toward All Modes and Produces Maximum Public Benefits from Public Investments

Federal decision makers face considerable uncertainty about the future of freight transportation coupled with considerable certainty that the federal deficit will be a long-term constraint on federal investment. At the same time, Congress will continue to face policy and funding decisions that will affect all freight modes and have a critical impact in shaping the nation's rail system and infrastructure. As we have noted in our past work,[43] a strategic systemwide approach to transportation planning and funding that focuses on all modes is increasingly important to meet expectations for more efficient freight transport, growing freight demand, and more connections between modes.

Federal funding constraints enhance the need for a strategic federal approach to freight infrastructure investment, and the implications of these constraints are a critical feature of a national freight policy. Given major projected demographic shifts and future federal health and retirement commitments, federal revenues may barely cover interest on the federal debt by 2040—leaving no money for either mandatory or discretionary programs. According to our simulations, balancing the budget could require cutting federal spending by as much as 60 percent, raising taxes by up to 2-1/2 times their current level, or some combination of the two.[44] We have concluded that the impending federal fiscal crisis will require a fundamental reexamination of all federal programs.[45] For example, our assessment of the federal highway grant program raised significant issues, such as the absence of a clear federal mission and role since the completion of the interstate highway system and the absence of a link between federal funding and goals or outcome measures.

DOT has taken an important step toward a more comprehensive freight strategy by publishing a draft *Framework for a National Freight Policy*[46] for comment. It is a step for which we found considerable support among public and private freight stakeholders. A systemwide, rather than a modal, perspective is critical to a national freight policy. As the AASHTO study emphasized, investments at the freight system level are needed to respond to nationally significant corridor choke points, intermodal connections, and urban rail interchanges.

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[43] GAO, *21st Century Challenges*, GAO-05-325SP (Washington, D.C.: Feb. 1, 2005), GAO, *Freight Transportation: Short Sea Shipping Option Shows Importance of Systematic Approach to Public Investment Decisions*, GAO-05-768 (Washington, D.C.: July 29, 2005), and GAO, *Freight Transportation: Strategies Needed to Address Planning and Financing Limitations*, GAO-04-165 (Washington, D.C.: Dec. 19, 2003).

[44] GAO, *Highway Finance: States' Expanding Use of Tolling Illustrates Diverse Challenges and Strategies*, GAO-06-554 (Washington, D.C.: Jun. 28, 2006).

[45] GAO-05-325SP.

[46] DOT, *(Draft) A Framework for a National Freight Policy*, (Washington, D.C.: Apr. 10, 2006).

With federal fiscal constraints as the backdrop, two major policy principles will need to be considered as DOT continues to develop this national policy. These principles are, first, to adopt a mode-neutral approach—one that takes a consistent policy and funding approach to all modes and establishes a level playing field for competition in the freight marketplace—and, second, to maximize public benefits—particularly benefits to the national transportation system—from public transportation investments.

Adopting a Mode-Neutral Approach

Under a mode-neutral approach, each mode would pay the full costs for the infrastructure facilities and services that it used as well as the costs that its use imposed on others—such as added air pollution, congestion, and accident risks[47]—through taxes and user fees. No single mode would be at a competitive disadvantage. A mode-neutral federal freight policy and investment strategy would be consistent with the competitive market's central role in the freight system. Encouraging a market-based approach and competition that fosters economic efficiency and innovation is a key consideration in dealing with the privately owned freight rail industry, as we have reported.[48]

Currently, as we have pointed out, federal programs treat different freight modes differently. For example, trucks and barges use infrastructure that is owned and maintained by the government, while rail companies use infrastructure that they pay to own and maintain. The trucking and barge industries pay fees and taxes to use this government-funded infrastructure, but their payments generally do not cover the costs they impose on highways and waterways, thereby giving the trucking and barge industries a competitive price advantage over railroads.[49] The most recent Federal

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[47] Transportation Research Board/National Research Council, *Paying Our Way: Estimating Marginal Social Costs of Freight Transportation*, National Academy Press (Washington, D.C.: 1996).

[48] GAO, *Physical Infrastructure: Crosscutting Issues Planning Conference Report*, GAO-02-139 (Washington, D.C.: Oct. 1, 2001).

[49] GAO, *Railroad Competitiveness: Federal Laws and Policies Affect Railroad Competitiveness*, GAO/RCED-92-16 (Washington, D.C.: Nov. 5, 1991).

Highway Administration (FHWA) highway cost allocation study[50] evaluates highway costs attributable to different vehicle classes and the extent to which their user fees cover their responsibility for highway costs. According to the study, combination unit trucks[51] paid 80 percent of their cost responsibility and the heaviest combinations paid half of their cost responsibility. The study concluded that only the very lightest combination trucks pay their share of federal highway cost responsibility. A recent CBO report[52] also concluded that trucks and barges do not pay their full share of highway costs and reported that rail may be at a competitive disadvantage, since other modes are effectively being subsidized. CBO also observed that if all modes do not pay their full costs, the result is inefficient use of roads and waterways and greater government spending than otherwise would be necessary if capacity investments are made in anticipation of demand that does not occur.

Maximizing Public Benefits from Public Transportation Investments

As DOT develops and applies a national freight policy, our second critical principle will be an important consideration—public investments should depend on clearly defined public benefits.[53] Benefit-cost analysis can be a useful tool to define benefits, as our expert panel on this subject concluded.[54] Because this analysis identifies the greatest net benefits by comparing the monetary value of each project's benefits and costs, it can help public and private stakeholders evaluate project alternatives.

States have had experience in evaluating whether rail projects could yield sufficient public benefits to warrant investments of public dollars in the projects, and their experience can inform a national freight policy. For example, the state of Washington's Freight Mobility Strategic Investment Board leverages transportation dollars by working with public and private stakeholders to fund projects that deliver public benefits. The board's project scoring criteria reflect anticipated benefits, such as freight mobility for the project area; freight mobility for the region, state, and nation; general mobility; safety; freight and economic value; environment; project partnership; consistency with regional and state plans; location on a Strategic Freight Corridor; and cost benefit.

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[50] DOT/Federal Highway Administration. Office of Transportation Policy Studies, *Addendum to the 1997 Federal Highway Cost Allocation Study Final Report* (Washington, D.C.: May 2000).

[51] Combination unit trucks are trucks that weigh 50,000-100,000 pounds.

[52] CBO, *Freight Rail Transportation: Long-Term Issues*, p. 22.

[53] This observation parallels the conclusion and recommendations by the Transportation Research Board (TRB), which called for the development of a national policy to promote better management and investment decisions to maintain and improve freight capacity. TRB described detailed principles to guide future decisions about using, enlarging, funding or regulating the freight transportation system. TRB, *Freight Capacity for the 21st Century*, (Washington, D.C.: 2003) pp. 5-13.

[54] GAO, *Highlights of an Expert Panel: The Benefits and Costs of Highway and Transit Investments*, GAO-05-423SP (Washington, D.C.: May 6, 2005).

However, federal decision makers have no such criteria to use in considering potential freight rail investments. As we have pointed out, the federal funding structure for surface transportation and federal program incentives tend to focus decision makers' attention on highway and transit projects, rather than on freight or freight rail concerns. And, although state and local transportation decision makers consider benefit-cost analyses, these analyses often do not have a decisive impact on investment decisions.[55] As DOT has noted, a fair, balanced approach to allocating public and private funding is a prerequisite for public-private partnerships.[56] We have also raised concerns about federal tax policies. For railroads, some industry groups have proposed freight rail tax credits to encourage investment. However, our work has shown that it is difficult to target tax credits to the desired activities and outcomes and ensure that tax credits generate the desired new investments, as opposed to substituting for investment that would have occurred anyway.[57]

Conclusions

The Staggers Rail Act achieved far-ranging benefits in helping to create and sustain a healthy and vibrant freight railroad industry, as well as an efficient rail transportation system that supports the important role freight plays in the nation's economy. Critical to the Staggers Rail Act was the concept of balance—on one hand, the act sought to allow rail carriers to earn adequate revenues so that they could meet their current and future capital needs. On the other hand, the act recognized the need for a remnant regulatory regime that would maintain reasonable rates and prohibit undue concentrations of market power in areas where no effective competition existed. The act recognized that it was vital for the federal government to promote competition and rely on it to set rates. Without a doubt, rates have decreased for most shippers, and most shippers are better off in the post-Staggers environment than they were previously. This outcome suggests that widespread and fundamental changes to the relationship between the railroads and their customers are not needed. Nevertheless, the evidence also suggests some basis for believing that—more than 25 years after the act's passage—the balance it envisioned has not been fully achieved.

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[55] GAO, *Surface Transportation: Many Factors Affect Investment Decisions*, GAO-04-744 (Washington, D.C.: Jun. 30, 2004).

[56] U.S. Department of Transportation, *Report to Congress on Public-Private Partnerships* (Washington, D.C.: December 2004).

[57] GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

The continued existence of pockets of potential captivity, together with the increase in traffic at higher thresholds, at a time when the railroads are, for the first time in decades, experiencing increasing economic health, raises the question whether rail rates in selected markets reflect justified and reasonable pricing practices, or an abuse of market power by the railroads. Answering this question requires a rigorous, national analysis of competitive markets. Our analysis provides an important first step; however, we are constrained by the inherent limitations of the *Carload Waybill Sample* and the available proxy measures for assessing captivity. In contrast, STB has the statutory authority to inquire into and report on railroad practices and could conduct a rigorous analysis of competition in the freight rail industry that would rely on more than sample data and could determine whether the inappropriate exercise of market power is occuring in specific markets. Should STB find evidence of abuse, it could consider several methods for creating the balance envisioned by the Staggers Rail Act. For example, STB could consider initiating a generally applicable rule making to address competition issues or prescribe specific remedies in response to a complaint.

In assessing competition within the freight rail industry, STB needs accurate data on railroad revenues. The data that STB currently collects—in particular, the use of the *Carload Waybill Sample* to report on the railroads' finances—are not always captured consistently, making it difficult to accurately track railroad revenues. Specifically, while we determined that, in general, the data in the Waybill were suitably reliable for our reporting purposes, we also found that some data, including data on fuel surcharges, were not accurately captured. Accurate data would provide for more accurate tracking of railroad revenues and railroad charges to potentially captive shippers and other shippers. This information would help STB to obtain a clearer picture of the actual fees paid by shippers.

STB is also responsible for ensuring the expeditious handling and resolution of rate disputes, but the current process for settling these disputes is ineffective. There are a number of potential alternatives to the current process, and STB has recognized the limits of the process and taken further action to improve it. These actions are commendable and need to be pursued; absent further action, the promise of the Staggers Rail Act and the balance it envisioned may never be fully realized.

These are difficult issues that require careful balancing of the railroads' need to earn adequate revenues with shippers' need for competition and reasonable rates during a time of uncertainty about the capacity of freight railroads to meet future demand for freight rail service. While predictions and scenarios for the future of freight rail vary, it is likely that multiple levels of government will continue to be involved in the nation's freight system. Additional investment in freight rail infrastructure can produce public benefits, and many state and local governments are involved in freight rail infrastructure projects. Congress has provided federal assistance as well, and further requests for and decisions about federal assistance to rail infrastructure are likely. Decision makers will be challenged to ensure that federal involvement is consistent with competition in the freight marketplace, reflects widespread public priorities, and offers benefits that warrant the commitment of federal funds. DOT's draft National Freight Policy represents a good start in this direction.

Recommendations for Executive Action

To ensure an appropriate balance between the interests of railroads and shippers, we recommend that the Chairman of the Surface Transportation Board take the following two actions:

- Undertake a rigorous analysis of competitive markets to identify the state of competition nationwide; in specific markets, determine whether the inappropriate exercise of market power is occuring; and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power. If the Chairman determines that STB requires more resources to conduct this analysis, then STB should request additional resources from Congress.
- Review STB's method of data collection to ensure that all freight railroads are consistently and accurately reporting all revenues collected from shippers, including fuel surcharges and other costs not explicitly captured in all railroad rate structures.

To ensure the efficiency and effectiveness of our nation's freight system, we are making the following recommendation to the Secretary of Transportation:

- As DOT continues to develop a national freight policy and a possible federal policy response, consider strategies to (1) sustain the role of competitive market forces by creating a level playing field for all freight modes and (2) recognize the fiscally constrained federal funding environment by developing mechanisms to assess and maximize public benefits from federally financed freight transportation investments.

Agency Comments and Our Evaluation

STB provided written comments on a draft of this report. These comments are presented and evaluated in appendix III. STB generally agreed with our assessment of the improving financial health of the freight railroad industry and potential public benefits for freight rail infrastructure projects. However, STB disagreed with our recommendation to undertake a rigorous analysis of competitive markets in the rail industry because it believed the findings underlying the recommendation were inconclusive, their on-going efforts will address many of our concerns, and a rigorous analysis would divert resources from other efforts. Specifically, STB stated that our recommendation was based on two findings—first, that rail rates have increased for some shippers and, second, that the amount of traffic with rates reflecting high R/VC ratios has increased in some areas. STB stated that recent increases in rail rates are not surprising and that R/VC ratios can increase when rates and costs are falling and that these findings do not suggest market abuses. STB also noted that it has several rule makings under way related to the standard rate relief process and the simplified rate relief process. STB suggested that, given the limitations on its resources and the aggressive agenda already under way, rather than undertake this competitive markets analysis, a more practical approach would be for STB to finish its reforms to ensure that captive shippers have an effective forum to seek rate relief if a railroad is charging unreasonable rates. Concerning our recommendation that STB review its method of data collection to ensure that all freight railroads are consistently and accurately reporting all revenues collected from shippers, STB stated that the revenue in question represents a small portion of all revenues and that revenue data submitted by freight railroads are audited and otherwise checked to ensure quality. Furthermore, STB has initiated a rule making to improve the tracking of fuel surcharges.

While STB's efforts have been helpful, we continue to believe that STB should undertake a rigorous analysis of competitive markets to identify the state of competition nationwide; in specific markets, determine whether the inappropriate exercise of market power is occuring; and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power. STB's comments do not accurately characterize the underlying support for our recommendation. We did not base this recommendation on an increase in rail rates or suggest that rate increases alone suggest increased captivity. On the contrary, we recognize that rates have declined and that available measures suggest that the extent of captivity has dropped. Furthermore, STB's response suggests that rail rates and the amount of traffic with high R/VC ratios were the only data we examined—they were not. We examined several factors, including data on the amount of tonnage originating in economic areas that have access to only one Class I railroad, data on the amount of tonnage traveling over 300 percent R/VC, and the amount of tonnage that originates in areas with access to only one Class I railroad and travels at rates that exceed the statutory threshold for rate relief. Our report explicitly acknowledges the limitations in the *Carload Waybill Sample* and of the proxy measures available for weighing captivity, including R/VC levels. At the same time, our analyses, when combined with comments from participants on our expert panel and interviews with shipper and railroad groups, suggest a reasonable possibility that shippers in selective markets may be paying excessive rates related to a lack of competition. This provides the impetus for STB—which has the statutory authority to inquire into and report on railroad practices—to analyze competitive markets in the rail industry and, where appropriate, consider the range of actions to address problems associated with the potential abnse of market power. Also, this analysis would rely on more than sample data and could analyze the exercise of market power in specific markets.

Regarding STB's position that it has several rule makings under way that address many of our concerns, we commend STB for recognizing and taking action to address problems with the rate relief process, but we believe action is needed beyond improvements to the rate relief process. These rule makings, if implemented, are designed to improve the processes available to shippers, after shippers have been charged a rate that they consider to be unreasonable. In contrast, we believe that an analysis of the state of competition and the possible abuse of market power, along with the range of options STB has to address competition issues, could more directly further legislatively defined goals to ensure effective competition among rail carriers as the preferred means to both promoting a sound rail transportation system and maintaining reasonable rates. Regarding STB's assertion that conducting a rigorous analysis of competition would divert resources away from its on-going initiatives, we modified our draft to recommend that STB request additional resources from Congress if it determines it needs more resources to conduct an analysis of competition. We also believe that STB should review its method of data collection to ensure that all freight railroads are consistently and accurately reporting all revenues. STB commented that it had already responded to this concern by proposing a standardized report for fuel surcharges; however, while we commend STB for its efforts to capture these data, we also note STB has not yet implemented standardized reporting of fuel surcharges and that other revenues besides fuel surcharges may not be included in the Waybill. STB also provided technical comments that we incorporated in this report, as appropriate.

We requested comments on a draft of this report from the Acting Secretary of Transportation or her representative. On September 21, 2006, DOT officials, including the Deputy Associate Administrator for Policy, Federal Railroad Administration, and the Chief Economist, Office of Transportation Policy, Office of the Secretary, provided us with oral comments on the draft. In its comments, DOT emphasized the need for the report to clearly recognize the rationale and importance of differential pricing; the nature and relatively small extent of potentially unreasonable pricing in the rail freight marketplace; and the impact of capacity constraints on rail pricing and services. DOT also suggested that our report should recognize certain factors, including that competition between railroads is not possible in all markets because the level of demand may not support more than one railroad, and that investment in freight rail infrastructure entails substantial private risk. In contrast, highway investment has been largely publicly financed. DOT did not take a position on our recommendation concerning the draft National Freight Policy, but stated that efforts are under way to develop more effective tools for gauging the extent to which proposed freight investments provide public benefits. DOT also endorsed the views contained in STB's September 15, 2006, letter (see app. III). We made changes to this report to reflect DOT's comments, as appropriate. DOT also provided a number of technical corrections, which we incorporated as appropriate.

We will send copies to the appropriate congressional committees, the Chair and Vice-Chairs of the Surface Transportation Board, and the Secretary of Transportation. We will also make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff has any questions, please contact me at (202) 512-2834 or heckerj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. See appendix V for a list of major contributors to this report.

JayEtta Z. Hecker
Director, Physical Infrastructure Issues

List of Congressional Requesters

The Honorable Daniel K. Inouye
Co-Chairman, Committee on Commerce, Science, and Transportation
United States Senate

The Honorable Conrad Burns
United States Senate

The Honorable Byron Dorgan
United States Senate

The Honorable Frank Lautenberg
United States Senate

The Honorable Trent Lott
United States Senate

The Honorable John McCain
United States Senate

The Honorable Mark Pryor
United States Senate

The Honorable Gordon Smith
United States Senate

Appendix I: Participants in GAO's Expert Panel

Louis S. Thompson (Moderator)
Principal
Thompson, Galenson and Associates, LLC

Paul Bingham
Global Insights

George Borts
Department of Economics
Brown University

George Eads
Vice President
CRA International

Robert Gallamore
Director
Transportation Center
Northwestern University

Darius Gaskins
Founding Partner
Norbridge, Inc.

Carl Martland
Senior Research Associate
Massachusetts Institute of Technology
Department of Civil and Environmental Engineering

Michael F. McBride
Partner
LeBouef, Lamb, Greene & MacRae, LLP

Gerard McCullough
Department of Applied Economics
University of Minnesota

Linda Morgan
Chair of the Transportation Practice Group
Covington & Burling, LLP

John V. Wells
Chief Economist
U.S. Department of Transportation

Appendix II: Objectives, Scope, and Methodology

We used the Surface Transportation Board's (STB) *Carload Waybill Sample* to identify railroad rates from 1985 through 2004 (the latest rate data available at the time of our review), which we then analyzed to determine rate changes. The *Carload Waybill Sample* is a sample of railroad waybills (in general, documents prepared from bills of lading authorizing railroads to move shipments and collect freight charges) submitted by railroads annually. We used these data to obtain information on rail rates across the industry, for certain commodities and for certain routes by shipment size and length of haul. According to STB officials, revenues derived from the *Carload Waybill Sample* are not adjusted for such things as year-end rebates and refunds that may be provided by railroads to shippers that exceed certain volume commitments.

Some railroad movements contained in the *Carload Waybill Sample* are governed by contracts between shippers and railroads. To avoid disclosure of confidential business information, STB disguises the revenues associated with these movements before making this information available to the public. Consistent with our statutory authority to obtain agency records, we obtained a version of the *Carload Waybill Sample* that did not disguise revenues associated with railroad movements made under contract. Therefore, the rate analysis presented in this report presents a truer picture of rail rate trends than analyses that may be based solely on publicly available information. Since much of the information contained in the *Carload Waybill Sample* is confidential, rail rates and other data contained in this report that were derived from this database have been aggregated at a level sufficient to protect this confidentiality.

We used rate indexes and average rates to measure rate changes over time. A rate index attempts to measure price changes over time by holding constant the underlying collection of items that are consumed (in the context of this report, items shipped). This approach differs from comparing average rates in each year because, over time, higher- or lower-priced items can constitute different shares of the items consumed. Comparing average rates can confuse changes in prices with changes in the composition of the goods consumed. In the context of railroad transportation, rail rates and revenues per ton-mile are influenced, among other things, by the average length of haul. Therefore, comparisons of average rates over time can be influenced by changes in the mix of long- and short-haul traffic. Our rate indexes attempted to control for the distance factor by defining the underlying traffic as 2004 commodity flows between pairs of census regions. To examine the rate trends on specific traffic corridors, we first chose a level of geographic aggregation for corridor end points. We defined end points as the regional economic areas defined by the Department of Commerce's Bureau of Economic Analysis. An economic area is a collection of counties in and about a metropolitan area (or other center of economic activity); there are 179 economic areas[1] in the United States, and each of the nation's 3,141 counties is included in an economic area.[2] We placed each corridor in one of three distance-related categories: 0 to 500 miles, 501 to 1,000 miles, and more than 1,000 miles. Although these distance categories are somewhat arbitrary, they represent reasonable proxies for short-, medium-, and long-distance shipments by rail.

To determine the areas with access to one or more Class I railroads, we obtained railroad systems data from the Department of Transportation, which accounted for trackage rights, mergers, and other industry developments affecting access. For issues related to revenue-to-variable cost ratios, we used data from the *Carload Waybill Sample* to identify the specific revenues and variable costs and to compute R/VC ratios for the commodities and markets we examined. Using this information, we then identified those commodities and areas whose R/VC ratios were above or below the 180 percent R/VC level, as well as those areas above the 300 percent R/VC level.

To identify the actions STB has taken to address competition and captivity concerns, we interviewed officials and reviewed information from all seven North American Class I railroads, several shipper groups and associations and STB officials; and we met with experts in the railroad industry. We reviewed characteristics of STB's current rate relief process, as well as changes STB has made to the process, and conducted a comprehensive analysis of STB cases since 2000. We also held an expert panel through the National Academy of Sciences, consisting of 11 individuals with expertise in the freight railroad industry and the economics of transportation deregulation. Moreover, we conducted a legal analysis of current statutes related to STB's authority. To discern potential alternatives, we reviewed pending legislation, testimonies before Congress, previous GAO reports, STB decisions, rule makings, and proposed rule makings, and conducted a summary analysis of interviews.

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[1] Our analysis included 177 economic areas because we did not include the two economic areas in Alaska and Hawaii.

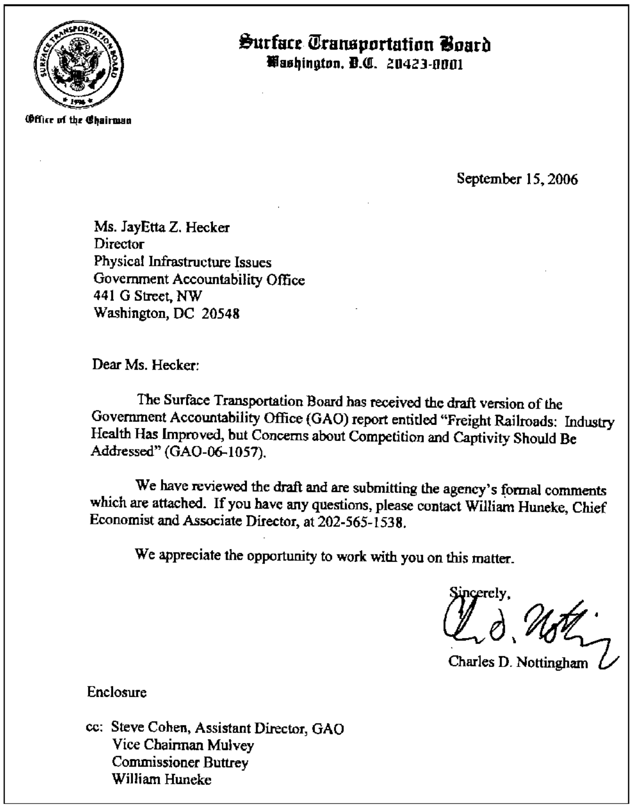
[2] The Bureau of Economic Analysis updated definitions of each economic area in November 2004.

To assess future freight demand and the freight railroad industry's ability to meet such demand, we reviewed transportation planning literature and forecasts of future freight rail demand and capacity in the United States. This review also included state freight plans and major freight rail projects. We synthesized information on freight and freight rail, as well as various forecasts to identify similar and dissimilar themes. We also reviewed involvement by the federal government in freight railroad projects, including related legislation and funding decisions. We interviewed several state and federal transportation officials to gather further information on public-private partnerships, freight railroad projects, and DOT's draft National Freight Policy. We also interviewed freight railroad representatives, financial market analysts, national association representatives, and transportation experts. For selected public-private partnerships, we analyzed the genesis of such projects, motivations for involvement from the public and private sectors, and benefit-cost analyses that were conducted to support project funding decisions.

We determined that the data used in this report were sufficiently reliable for the purpose of our review. We conducted our review from June 2005 to August 2006 in accordance with generally accepted government auditing standards.

Appendix III: Comments from the Surface Transportation Board

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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Surface Transportation Board
Washington, D.C. 20423-0001

Office of the Chairman

September 15, 2006

Ms. JayEtta Z. Hecker
Director
Physical Infrastructure Issues
Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Hecker:

The Surface Transportation Board has received the draft version of the Government Accountability Office (GAO) report entitled "Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Captivity Should Be Addressed" (GAO-06-1057).

We have reviewed the draft and are submitting the agency's formal comments which are attached. If you have any questions, please contact William Huneke, Chief Economist and Associate Director, at 202-565-1538.

We appreciate the opportunity to work with you on this matter.

Sincerely,

Charles D. Nottingham

Enclosure

cc: Steve Cohen, Assistant Director, GAO
Vice Chairman Mulvey
Commissioner Buttrey
William Huneke

Comments of the Surface Transportation Board

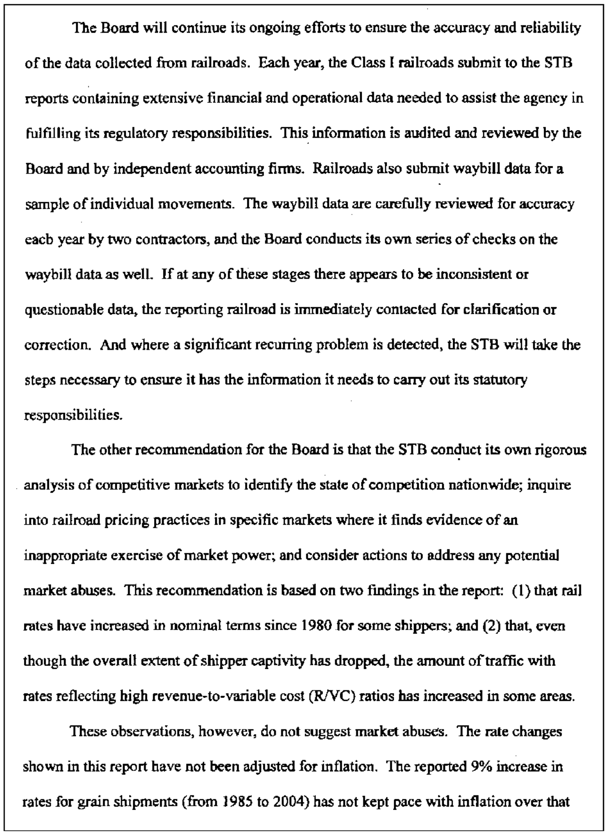
"Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Captivity Should be Addressed" (GAO-06-1057)

September 15, 2006

The STB appreciates the opportunity to comment on this report and commends the GAO staff for their efforts in studying these complex issues. We are pleased with the report's finding that the changes in the rail industry since the Staggers Act have been positive. As the report shows, railroads have seen their productivity and financial health improve, and inflation-adjusted rail rates have fallen as carriers have passed cost savings back to their customers. We share GAO's concern that further rail investment is needed to meet the significant rise in demand predicted over the next 10 to 15 years, and that further investment would provide broad public benefits by improving highway traffic flow, air quality, and safety at the national, state and local levels. We also agree with GAO's ultimate finding that "widespread and fundamental changes to the relationship between the railroads and their customers are not needed."

See comment 1.

Based on its national study into the state of competition, GAO offers two recommendations for Board action. One recommendation is that the Board review its data collection methods to ensure that all freight revenues are consistently and accurately reported. For example, the report highlights the current inconsistent treatment by railroads of their fuel surcharge revenues. The agency has already responded to this industry concern by proposing standardized monthly reports of Class I railroads' fuel surcharges. Moreover, as GAO notes, the amount of revenues reported as "miscellaneous revenue" represents less than 1.5% of the total freight rail revenue reported for 2004.



See comment 2.

The Board will continue its ongoing efforts to ensure the accuracy and reliability of the data collected from railroads. Each year, the Class I railroads submit to the STB reports containing extensive financial and operational data needed to assist the agency in fulfilling its regulatory responsibilities. This information is audited and reviewed by the Board and by independent accounting firms. Railroads also submit waybill data for a sample of individual movements. The waybill data are carefully reviewed for accuracy each year by two contractors, and the Board conducts its own series of checks on the waybill data as well. If at any of these stages there appears to be inconsistent or questionable data, the reporting railroad is immediately contacted for clarification or correction. And where a significant recurring problem is detected, the STB will take the steps necessary to ensure it has the information it needs to carry out its statutory responsibilities.

See comment 3.

The other recommendation for the Board is that the STB conduct its own rigorous analysis of competitive markets to identify the state of competition nationwide; inquire into railroad pricing practices in specific markets where it finds evidence of an inappropriate exercise of market power; and consider actions to address any potential market abuses. This recommendation is based on two findings in the report: (1) that rail rates have increased in nominal terms since 1980 for some shippers; and (2) that, even though the overall extent of shipper captivity has dropped, the amount of traffic with rates reflecting high revenue-to-variable cost (R/VC) ratios has increased in some areas.

See comment 4.

These observations, however, do not suggest market abuses. The rate changes shown in this report have not been adjusted for inflation. The reported 9% increase in rates for grain shipments (from 1985 to 2004) has not kept pace with inflation over that same time period. And the modest increase in rates from 2000 to 2004 is not surprising, given the escalation in costs during that time period.

See comment 5 and 6.

The analysis of R/VC ratios is also inconclusive. For example, in Figure 19, it is reported that the amount of grain traffic transported from Minot to Portland at rates with an R/VC ratio above 300% increased from 1985-2004. But as shown in Figure 9, even without accounting for inflation, grain rates per ton-mile from Minot to Portland had fallen. Thus, the change in R/VC ratios must be due to a drop in costs per ton-mile, as more grain is shipped in lower-cost shuttle trains or the railroad has implemented other cost-saving measures. R/VC ratios do not provide a reliable measure of changes in captivity over time, because they can increase even when rates are falling where a carrier's costs are also falling. For example, as GAO has previously observed, if rail revenues are $2 and variable costs are $1, the R/VC ratio would be 200%. However, if revenues decreased to $1.50 and variable costs decreased to $0.50, the ratio becomes 300%. Under this scenario, "although railroads have passed all cost reductions along to shippers in terms of lower rates, the increased R/VC ratio makes it appear as though the shipper is worse off." GAO/RCED-99-93, *Railroad Regulation* at 65 (April 1999).

See comment 7.

See comment 8.

It is noteworthy that the STB has several important rulemakings underway which bear directly on most of GAO's concerns. Specifically, GAO reports widespread belief that the STB's standard rate relief process is inaccessible to most shippers because it is too expensive, time consuming, and complex. Earlier this year, the agency instituted a rulemaking intended to resolve contentious issues in its standard rate relief process. If implemented, these changes should reduce the complexity of those cases and dramatically reduce the cost by simplifying the evidentiary inquiry. Final rules will be issued this fall.

GAO also concludes that the agency's simplified guidelines – which were defended vigorously by the STB and the shipper community when challenged by the railroad community in federal court – have not proven effective because no captive shipper has used them. However, earlier this year the STB launched a major rulemaking to reform and modernize its simplified rate relief guidelines to ensure that all shippers have an effective forum to bring rate complaints. The proposed revisions are the culmination of public hearings and considerable internal study by STB staff. Comments from over 65 parties are expected by the end of this year, with final rules to follow early next year. These important reforms will be pursued concurrently with the agency's regular docket of cases requiring Board adjudication.

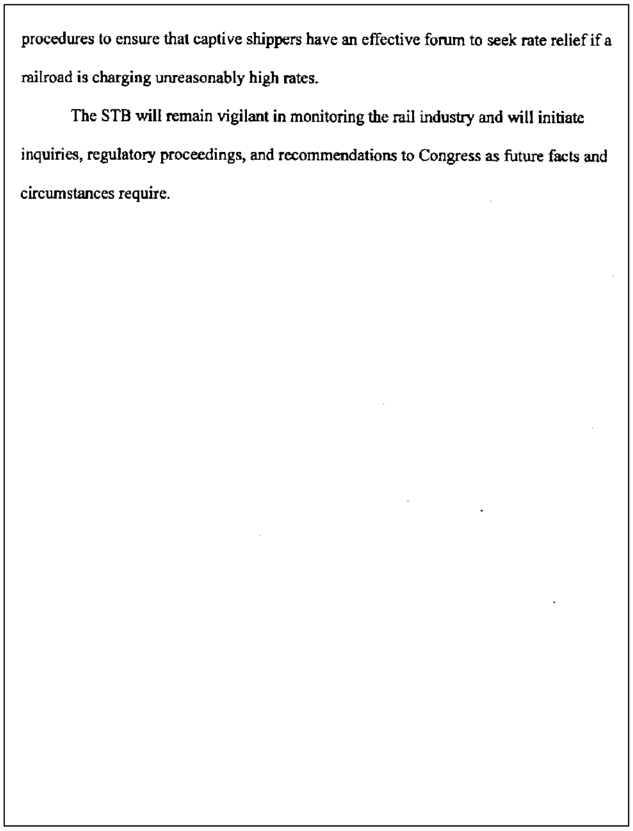
See comment 8.

Given the aggressive agenda already underway at the Board, we are hesitant to divert resources and attention away from these pending initiatives to undertake another prolonged national study. GAO has already used its full resources to carefully review the only comprehensive dataset for railroad pricing; interviewed and reviewed information from the railroads, shippers, economists, and experts in the rail industry; and heard from a panel of experts in the freight rail industry and in the economics of freight rail transportation. Finding nothing conclusive, GAO recommends that this far-smaller agency conduct yet another analysis. Because most of GAO's concerns involve the possibility that some shippers may be paying excessive rates, we believe that a far more practical approach is for the STB to finish the important reforms to its rate complaint

See comment 9.

See comment 6.

See comment 10.



procedures to ensure that captive shippers have an effective forum to seek rate relief if a railroad is charging unreasonably high rates.

The STB will remain vigilant in monitoring the rail industry and will initiate inquiries, regulatory proceedings, and recommendations to Congress as future facts and circumstances require.

The following are GAO's comments on the Surface Transportation Board's letter dated September 15, 2006.

GAO Comments

1. STB commented that we conducted a national study into the state of competition. We did not conduct such a study. Our study included a broad focus on changes in the freight railroad industry since the Staggers Rail Act, the actions STB has taken to address concerns about competition and captivity, and future freight demand and capacity. The data we collected and analysis we performed—such as a review of rate changes over 20 years—were too broad to represent a national study of the state of competition. It is the limitations in the scope of our analysis of competition, along with limitations in the data available to us and a reasonable possibility that shippers in selected markets may be paying excessive rates, which led us to recommend that STB conduct a more rigorous analysis of competition.

2. STB commented that it has already addressed our recommendation to improve data collection by proposing standardized monthly reports of fuel surcharges and also described its efforts to ensure the accuracy and reliability of data in the Waybill. We commend STB for its recent action on fuel surcharges, which occurred during our review, but we also note STB has not yet implemented standardized reporting of fuel surcharges. In addition, other revenues besides fuel surcharges may not be included in the Waybill. Specifically, revenues generated through railcar auctions and congestion fees may not be included. While the reported miscellaneous revenue is a small percentage of all revenue, it is not known how much miscellaneous revenue is not reported. Complete data would provide for more accurate tracking of railroad revenues and would help STB to obtain a clearer picture of actual fees paid by shippers. While we commend STB for its actions to audit and review Waybill data, these accuracy checks do not address our concern that STB is not collecting the full range of revenue data.

3. STB commented that our recommendation for STB to conduct an analysis of competition is based on two findings—that rail rates have increased since 1980 and that the amount of traffic with high R/VC ratios has increased in some areas. Our recommendation is not based on these two findings, but on an analysis of multiple sources, such as data on the amount of tonnage originating in economic areas that have access to only one Class I railroad, data on the amount of tonnage traveling over 300 percent R/VC, and the amount of tonnage that originates in areas with access to only one Class I railroad and travels at rates that exceed the statutory threshold for rate relief. This analysis

provides an important first step in assessing competitive markets nationally; but it is imperfect, given the limitations of measures used to weigh captivity and limitations in the *Carload Waybill Sample*. The results of our analysis, when combined with comments from participants on our expert panel and interviews with shipper and railroad groups, suggest a reasonable possibility that shippers in selective markets may be paying excessive rates related to a lack of competition in these markets. It is precisely the inconclusiveness of the available data—and STB's authority and responsibility to monitor and ensure effective competition in the freight rail industry—that led us to recommend a rigorous analysis of competition by STB. Also, we examined rates since 1985, not 1980.

4. STB commented that an increase in rates does not suggest market abuses and that the rate changes in our report were not adjusted for inflation. We agree that a change in a rate does not necessarily suggest the exercise of market power. While our rates were not adjusted for inflation, we constructed rate indexes, which account for changes in traffic patterns over time that could affect revenue statistics. We also included the price index for the GDP to provide a measure for inflation. However, our recommendation is not based on recent rate increases. Our recommendation is based on our analyses of multiple sources, such as data on the amount of tonnage originating in economic areas that have access to only one Class I railroad, data on the amount of tonnage traveling over 300 percent R/VC, and the amount of tonnage that originates in areas with access to only one Class I railroad and travels at rates that exceed the statutory threshold for rate relief.

5. STB commented that figure 19 shows an increase in grain traffic which traveled at rates above 300 percent R/VC and figure 9 shows that grain rates per ton-mile had fallen along that same route, so the change in R/VC must be due to a drop in costs per ton-mile. We disagree that the change in R/VC in figure 19 must be due to a drop in costs per ton-mile. Figure 19 shows only the amount of traffic on the route that traveled at rates above 300 percent R/VC, while figure 9 shows the cents per ton-mile for all traffic along that route (not just traffic that traveled at rates above 300 percent R/VC). Therefore, the decrease in cents per ton mile shown in figure 9 may reflect a decrease in rates for traffic along that route that traveled at rates below 300 percent R/VC.

6. STB commented that the measures used in our analysis are not conclusive. The fact that our analysis is inherently limited by available data and proxy measures lends more weight to our recommendation.

Specifically, our analysis provides an important first step in assessing competitive markets nationally, but it is imperfect given the limitations of measures used to weigh captivity and limitations in the *Carload Waybill Sample*. We do not conclusively state that there are shippers who are captive to one railroad and paying rates that reflect an abuse of market power. However, the results of our analysis, when combined with comments from participants on our expert panel and interviews with shipper and railroad groups, suggest a reasonable possibility that shippers in selective markets may be paying excessive rates related to a lack of competition in these markets. We believe that STB is the agency that has the authority and responsibility to conduct an inquiry into the potential abuse of market power and utilize its range of options to address competition issues.

7. STB commented that R/VC levels do not provide a reliable measure of changes in captivity because they can increase when rates are falling. We agree that an analysis of R/VC levels is not a conclusive measure of the use of market power. However, the use of R/VC as an indicator of railroad pricing power is well-documented both by Congress in the Staggers Rail Act and by STB, which uses R/VC levels in its process for determining unreasonable rates. While we acknowledge the limitations of the ratio in our report, and even include an example like the one cited above, we believe that R/VC ratios can be used as one of several proxy measure to determine potential captivity. In fact, STB refers to traffic traveling at or above 180 percent R/VC as "potentially captive."

8. STB commented that they have several important rule makings under way which bear directly on our concerns, including changes to the standard and simplified rate relief processes. While we commend STB for taking action to improve its rate relief processes, we note that these rule makings are designed to make changes to the standard and simplified rate relief processes and are not designed to analyze the state of competition or the possible abuse of market power. In contrast, we believe that an analysis of the state of competition or the possible abuse of market power, along with the range of options STB has to address competition issues, could more directly further legislatively defined goals to ensure effective competition among rail carriers as the preferred means to both promoting a sound rail transportation system and maintaining reasonable rates.

9. STB commented that it is hesitant to divert resources away from its pending initiatives to respond to our recommendation. We have modified our draft to recommend that, if STB determined that it needs more resources to undertake a rigorous analysis of competitive

markets to identify the state of competition nationwide, it should request additional resources from Congress.

10. STB commented that, as a small agency, a more practical approach to addressing concerns about captive shippers would be for STB to continue reforming its rate complaint procedures, rather than conduct another analysis. While we commend STB for continuing its efforts to improve its standard and simplified rate relief processes, these rule makings will not address our concerns. Specifically, these rule makings are designed to improve processes available to shippers *after* they have been charged a rate they consider to be unreasonable; these rule makings are not designed to analyze the state of competition or the possible abuse of market power. In contrast, we believe that an analysis of the state of competition or the possible abuse of market power, along with the range of options STB has to address competition issues, could more directly further legislatively defined goals to ensure effective competition among rail carriers as the preferred means to both promoting a sound rail transportation system and maintaining reasonable rates. We believe that STB is the agency that is uniquely positioned to inquire into and report on railroad practices and could conduct an analysis of competition that would rely on more than sample data and could determine whether the inappropriate exercise of market power is occuring in specific markets. STB has the authority to subpoena witnesses and records. Following its inquiry, STB could also consider initiating a generally applicable rule making to address competition issues or prescribe specific remedies in response to a complaint. We recognize that STB has limited resources, and we have modified our draft to recommend that, if STB determines that it needs more resources to conduct an analysis of competition, it should request additional resources from Congress.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

JayEtta Z. Hecker, (202) 512-2834

Staff Acknowledgments

In addition to those named above, individuals making key contributions to this report include Ashley Alley, Steve Brown, Matthew T. Cail, Sheranda S. Campbell, Steve Cohen, Elizabeth Eisenstadt, Libby Halperin, Richard Jorgenson, Tom McCool, John Mingus, Josh Ormond, and John W. Shumann.

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A STUDY OF COMPETITION IN THE U.S. FREIGHT RAILROAD INDUSTRY AND ANALYSIS OF PROPOSALS THAT MIGHT ENHANCE COMPETITION

Volumes 1-3

Laurits R. Christensen Associates, Inc.
Madison, WI

November 2008

Final Report

Prepared for
The Surface Transportation Board
Washington, DC

Report Contents

ACKNOWLEDGEMENTS

ABBREVIATIONS

EXECUTIVE SUMMARY

VOLUME 1: DESCRIPTION OF THE U.S. FREIGHT RAILROAD INDUSTRY

ABBREVIATIONS
LIST OF FIGURES
LIST OF TABLES
CHAPTER 1 INTRODUCTION AND OVERVIEW OF VOLUME 1
CHAPTER 2 OVERVIEW OF THE U.S. RAILROAD INDUSTRY
CHAPTER 3 ECONOMIC CHARACTERISTICS OF NETWORK INDUSTRIES WITH COMPARISONS TO THE RAILROAD INDUSTRY
CHAPTER 4 REVIEW OF ECONOMIC STUDIES OF RAILROAD PRICING, COSTS, PRODUCTIVITY, AND INDUSTRY STRUCTURE
CHAPTER 5 THE CURRENT CONCERNS ABOUT THE PERFORMANCE OF THE U.S. FREIGHT INDUSTRY
REFERENCES

VOLUME 2: ANALYSIS OF COMPETITION, CAPACITY, AND SERVICE QUALITY

ABBREVIATIONS
LIST OF FIGURES
LIST OF TABLES
CHAPTER 6 INTRODUCTION AND OVERVIEW OF VOLUME 2
CHAPTER 7 DATA AND METHODOLOGY
CHAPTER 8 OVERVIEW OF INDUSTRY PERFORMANCE
CHAPTER 9 RAILROAD COSTS AND TECHNOLOGY
CHAPTER 10 AN OVERVIEW OF COSTS AND REVENUE
CHAPTER 11 RAILROAD PRICING BEHAVIOR
CHAPTER 12 ANALYSIS OF COMPETITION: COAL
CHAPTER 13 ANALYSIS OF COMPETITION: CORN AND WHEAT
CHAPTER 14 ANALYSIS OF COMPETITION: CHEMICALS
CHAPTER 15 ANALYSIS OF COMPETITION: INTERMODAL SHIPMENTS

CHAPTER 16 ANALYSIS OF RAILROAD CAPACITY

CHAPTER 17 SERVICE QUALITY

CHAPTER 18 CONCLUSIONS ON THE STATE OF COMPETITION IN THE U.S. FREIGHT RAILROAD INDUSTRY

REFERENCES

VOLUME 3: POLICY ANALYSIS AND FUTURE DIRECTIONS FOR RESEARCH

ABBREVIATIONS

LIST OF FIGURES

LIST OF TABLES

CHAPTER 19 INTRODUCTION AND OVERVIEW OF VOLUME 3

CHAPTER 20 HISTORICAL AND CURRENT RAILROAD LEGISLATION AND REGULATION

CHAPTER 21 DESCRIPTION OF RECENT RAILROAD INDUSTRY POLICY PROPOSALS

CHAPTER 22 ECONOMIC ANALYSIS OF PROPOSED POLICY CHANGES

CHAPTER 23 CONCLUSIONS AND FUTURE DIRECTIONS

REFERENCES

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William Brennan of the STB Office of Economics served as the STB project manager and our liaison with the STB. He was always prompt and helpful in his responses to our inquiries. He managed the project in a manner completely consistent with the stated goal of this project—an independent assessment of the U.S. freight railroad industry.

Inevitably, we have inadvertently forgotten to include someone on this list. We apologize for the oversight and offer our sincere gratitude.

ABBREVIATIONS

3-R Act	Regional Rail Reorganization Act of 1973
4-R Act	Railroad Revitalization and Regulatory Reform Act of 1976
AAR	Association of American Railroads
AFC	Average Fixed Cost
ATC	Average Total Cost
AVC	Average Variable Cost
BEA	Bureau of Economic Analysis
BLS	Bureau of Labor Statistics
the Board	Surface Transportation Board
BNSF	Burlington Northern Santa Fe
CAPM	Capital Asset Pricing Model
CBO	Congressional Budget Office
CCO	Common Carrier Obligation
CFR or C.F.R.	Code of Federal Regulations
CMP	Constrained Market Pricing
CN	Canadian National
the Commission	Interstate Commerce Commission
CP	Canadian Pacific
CSX	CSX Corporation
CWS	Carload Waybill Sample
DCF	Discounted Cash Flow
DOJ	Department of Justice
DOT	Department of Transportation
FCC	Federal Communications Commission
FDC	Fully Distributed Costing (methodology)
FTC	Federal Trade Commission
GAO	Government Accountability Office
GDP	Gross Domestic Product
ICC	Interstate Commerce Commission (also referred to as "the Commission")
ICCTA	ICC Termination Act of 1995
KCS	Kansas City Southern
MC	Marginal Cost

MFP	Multi-Factor Productivity
NS	Norfolk Southern
PAF	Productivity Adjustment Factor
PPI	Producer Price Index
R/VC	Revenue to Variable Cost ratio
R-1	Form R-1 data from Class I railroads' Annual Reports filed with the STB
RCAF	Rail Cost Adjustment Factor
RCAF-A	Adjusted RCAF
RCAF-U	Unadjusted RCAF
RPM	Railroad Performance Measures
RPTM	Revenue per Ton-Mile
SAC	Stand-Alone Cost (methodology)
SARR	Stand-Alone Railroad (analysis)
SPLC	Standard Point Location Code
STB	Surface Transportation Board
STCC	Standard Transportation Commodity Code
TFP	Total Factor Productivity
TTX	TTX Company
UP	Union Pacific
URCS	Uniform Rail Costing System
USC or U.S.C.	United States Code
USO	Universal Service Obligation
USDA	U.S. Department of Agriculture

Executive Summary Contents

EXECUTIVE SUMMARY ES-1
- INTRODUCTION ES-1
  - The 2006 GAO Report ES-1
  - The Current Study ES-3
  - Organization of this Executive Summary ES-4
- ES1 CURRENT STATE OF COMPETITION IN U.S. FREIGHT RAILROAD INDUSTRY ES-6
  - Characteristics of U.S. Freight Railroad Traffic ES-6
  - Structure of U.S. Freight Railroad Industry ES-8
  - Assessment of Shipper Captivity ES-10
  - R/VC Data Issues ES-11
  - R/VC and Market Structure Factors ES-12
  - Evaluating "Captivity" and Market Structure Factors ES-14
  - Trends in Rates ES-15
  - Trends in Input Prices and Productivity ES-16
  - Trends in Economic Costs ES-18
  - Economies of Density and Differential Pricing by Commodity ES-22
  - Financial Viability ES-26
- ES2 CURRENT AND NEAR-FUTURE CAPACITY CONSTRAINTS ES-27
- ES3 CAPACITY INVESTMENT ES-30
- ES4 IMPACT OF CAPACITY CONSTRAINTS ON COMPETITION ES-32
  - Stakeholder Feedback on Causes of Capacity Constraints ES-32
  - Assessment of the Impact of Capacity Constraints ES-33
- ES5 SERVICE QUALITY ISSUES ES-34
  - Stakeholder Feedback on Service Quality ES-34
  - Train Speed as an Indicator of Service Quality ES-35
  - Variability in Average Speed by Train Type ES-37
- ES6 IMPLICATIONS FOR PROPOSED POLICY CHANGES ES-38
- ES7 CONCLUSIONS AND FUTURE RESEARCH DIRECTIONS ES-42
  - Captivity and Effective Competition ES-42
  - Service Quality ES-42
  - Capacity ES-43
  - Cost Shifting ES-43
  - Fuel Surcharges ES-43
  - Issues Related to Class II and Class III Railroads ES-43
  - Critical Evaluation of Rail Demand Growth Projections ES-44
  - Reduction in Railroad Network Access ES-44
- REFERENCES

LIST OF FIGURES

FIGURE ES-1 CLASS I PROPORTIONS OF U.S. RAILROAD MILES OF TRACK OWNED AND OPERATED 1987-2006 .... ES-9
FIGURE ES-2 CLASS I RATIO OF NET TON-MILES TO TOTAL TRACK MILES 1987-2006 .... ES-10
FIGURE ES-3 R/VC AVERAGES BY ORIGIN COUNTY FOR WHEAT SHIPMENTS 2001-2006 CARLOAD WAYBILL SAMPLE ES-13
FIGURE ES-4 COUNTY-LEVEL EFFECTS OF MARKET STRUCTURE VARIABLES IN WHEAT PRICING MODELS ON REAL REVENUE PER TON-MILE ES-14
FIGURE ES-5 INDUSTRY-WIDE INDEXES CONSTRUCTED FROM CARLOAD WAYBILL SAMPLE 1987 = 100 .... ES-15
FIGURE ES-6 RCAF-A, 1989-2008 .... ES-16
FIGURE ES-7 MFP GROWTH DIFFERENTIAL: RAILROAD INDUSTRY V. PRIVATE BUSINESS SECTOR ES-18
FIGURE ES-8 CLASS I AVERAGE TOTAL COST, AVERAGE VARIABLE COST, AND AVERAGE FIXED COST (YEAR 2000 DOLLARS) ES-19
FIGURE ES-9 CLASS I INDUSTRY MARKUP RATIOS ES-20
FIGURE ES-10 CLASS I INDUSTRY RATIO OF AVERAGE RPTM TO AVERAGE TOTAL COST ES-21
FIGURE ES-11 RAILROAD INDUSTRY LERNER MARKUP INDEX ES-22
FIGURE ES-12 EARNINGS PER SHARE 1997-2006 .... ES-27
FIGURE ES-13 CAPITAL SPENDING/REVENUE 1997-2006 .... ES-31
FIGURE ES-14 CHANGES IN AVERAGE SPEED BY RAILROAD AND TRAIN TYPE, 1999-2005 .... ES-36
FIGURE ES-15 STYLIZED REPRESENTATION OF RAILROAD INTERCHANGE AND LENGTH-OF-HAUL ECONOMIES ES-40

LIST OF TABLES

TABLE ES-1 TON-MILES OF FREIGHT BY MODE ES-7
TABLE ES-2 RAIL SHIPMENTS BY COMMODITY GROUPING, 2007 .... ES-7
TABLE ES-3 PERCENT OF TONS AND TON-MILES BY R/VC CATEGORY 2000-2001 V. 2005-2006 CARLOAD WAYBILL SAMPLE DATA ES-11
TABLE ES-4 CORRELATIONS OF ORIGIN COUNTY* R/VC WITH REVENUE PER TON-MILE AND MARKET STRUCTURE FACTORS, 2001-2006 DATA, SELECTED COMMODITIES ES-12
TABLE ES-5 GROWTH IN RCAF-U COMPONENTS AVERAGE ANNUAL GROWTH IN PRICES, 1994Q1-2008Q2 .... ES-17
TABLE ES-6 ESTIMATED MEDIAN-ADJUSTED MARGINALCOSTS ANDMARKUPS, ... ES-23
TABLE ES-7 VARIABILITY IN AVERAGE TRAIN SPEED BY RAILROAD AND TRAIN TYPE ES-38
TABLE ES-8 LIKELY ECONOMIC EFFECTS OF VARIOUS OPEN-ASSESS PROPOSALS ES-39

EXECUTIVE SUMMARY

A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition

INTRODUCTION

This report presents the findings of an independent study of the competitive state of the U.S. freight railroad industry performed by the study team assembled by Christensen Associates and commissioned by the U.S. Surface Transportation Board (STB). In conducting this study, the Christensen Associates study team has received cooperation from the STB and numerous railroad industry stakeholders including railroads, various shipper group organizations, numerous individual shippers, government organizations, academics, and other stakeholders. The study team also assembled an Advisory Panel with representatives from a broad cross-section of industries, groups, and stakeholders. While valuable insights and assistance were obtained by the study team from these various groups, no individual, government agency, railroad, shipper, or any other industry stakeholder has influenced the findings of this study. The findings presented and conclusions reached in this report are the professional judgments and opinions of the Christensen Associates railroad study team.

The U.S. freight railroad industry has undergone a remarkable transformation since 1980 when Congress passed The Staggers Rail Act. In the decades preceding the passage of this seminal act, railroads suffered traffic losses that led to widespread insolvencies. The deregulation of the railroad industry ushered in increased market flexibility, competitive and differential rates for rail service, and a climate open to innovation. In the years following the passage of The Staggers Act, the railroad industry experienced dramatic reductions in costs and increased productivity, which yielded higher returns for carriers and lower inflation-adjusted rates for shippers. Thus both railroads and their customers benefited from regulatory reform.

The 2006 GAO Report

Despite the benefits of deregulation, including improved financial performance of railroads and constant dollar rate declines, the railroad industry's stakeholders continue to be concerned over competition, captivity, rates, service performance, and financial viability. Largely due to Congressional concern over the appropriate balancing of railroad and shipper interests, and the continued viability and ability of the railroad industry to fulfill demands for its services, the U.S. Government Accountability Office (GAO) has issued several reports on the freight railroad industry since the passage of the Staggers Act:

> Policymakers continue to believe that the federal government should provide a viable process to protect shippers against unreasonably high rates, as well as address competition issues, while still balancing the interests of both railroads and shippers. Over the past 10 years, significant consolidation has taken place in the freight railroad industry, while railroads—particularly Class I railroads—have seen their productivity and financial health improve. Railroad officials worry that any attempt to increase economic regulation will reduce carriers' ability to earn sufficient revenues and limit future infrastructure investment. At the same time, a number of academic and government studies are predicting a significant increase in the demand for freight rail over the next 10 to 15 years.[1]

The 2006 GAO report noted that, after a long-term downward trend in railroad rates since passage of the Staggers Act, increases began to occur in the early 2000s:

> Between 1985 and 2000, rail rates generally declined, but then increased slightly from 2001 through 2004. Although rates have declined since 1985, they have not done so uniformly, and rates for some commodities are significantly higher than rates for others. Several factors could have contributed to recent rate increases, including broad changes in the domestic and world economy, the emergence of a capacity constrained environment in which demand exceeds supply, and consolidation in the 1990s in the industry leading to changes in competition. Other costs, such as fuel surcharges, have also shifted to shippers, ...[2]

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[1] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006, pp. 1-2.

[2] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006, p. 3.

The question posed by the GAO was whether the observed pattern in railroad rates was the reflection of economic market forces or "a possible abuse of market power:"

> Some concerns about competition and captivity in the industry remain because traffic is concentrated in fewer railroads. It is difficult to determine precisely how many shippers are captive because available proxy measures can overstate or understate captivity. In addition, STB does not accurately collect railroad revenue data. Nevertheless, our analysis of available measures indicates that the extent of captivity appears to be dropping, but the percentage of industry traffic traveling at rates substantially over the statutory threshold for rate relief has increased. For example, the amount of traffic traveling at rates over 300 percent of the railroad's variable cost increased from 4 percent in 1985 to 6 percent in 2004. Furthermore, some areas with access to one Class I railroad have higher percentages of traffic traveling at rates that exceed the statutory threshold for rate relief. These findings may reflect reasonable economic practices by the railroads in an environment of excess demand, or they may indicate a possible abuse of market power.[3]

The Current Study

Based on these observations and concerns, the GAO recommended that the STB conduct a rigorous analysis of the state of U.S. railroad competition:

> We are recommending that STB conduct a rigorous analysis of the state of competition nationwide and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power.[4]

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[3] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed,* GAO-07-94, October 6, 2006, p. 3.

[4] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed,* GAO-07-94, October 6, 2006, pp. 3-4.

In response to the GAO's call for further study, the STB released an RFP for an analysis of the current state of competition in the U.S. railroad industry. A contract was subsequently awarded to the team assembled by Christensen Associates. As part of this study, we were directed to consider actions to address problems associated with the exercise of market power in the railroad industry.

Prior to initiating quantitative research, we conducted a qualitative research phase of our project. This qualitative phase primarily consisted of obtaining input from a broad spectrum of railroad industry stakeholders. The purpose of our qualitative research was to obtain railroad industry stakeholders' input on the important issues facing the industry—e.g., competition, rates, capacity, service quality—and to ensure, to the extent possible,[5] that these perspectives were considered in our study. We conducted our qualitative research in a manner that provided open access to any stakeholder who desired to provide input to us. We accomplished this through two approaches for soliciting input. First, we initiated contact with stakeholders in various targeted groups and conducted interviews in person and also over the phone. In addition to initiating contact with stakeholders, we established a website (www.lrca.com/railroadstudy) to provide a means by which any interested party could reach us. We obtained extensive stakeholder input that greatly assisted in the focus of our research efforts and also indicated areas where further investigation is warranted.

Our report is organized in three volumes: Volume 1 presents a description of the U.S. freight railroad industry. Volume 2 contains our quantitative analysis of industry competition, capacity, and service quality. Volume 3 presents our analysis of policy changes that others have proposed for the railroad industry.

Organization of this Executive Summary

In our approach to analyzing the competitive state of the U.S. freight railroad industry, we identified five fundamental questions. This Executive Summary reports the key findings of our study in relation to these questions:

- What is the current state of competition in the U.S. railroad industry?
- What are the current and near future capacity constraints in the U.S. railroad industry?
- How do competition and regulation in the railroad industry impact capacity investment?

---

[5] Some of the issues raised by stakeholders were outside the scope of our study, while data limitations prevented us from thoroughly examining a few issues.

- How do capacity constraints impact competition?
- How do competition, capacity constraints, and other factors influence the quality of service?

In focusing on these questions, our study also sheds light on whether the current situation reflects reasonable economic practices by the railroads. Addressing these questions also provides important input into our economic analysis of recent proposals for railroad industry policy changes. Our study finds that:

- Class I railroads' rates (real revenue per ton-mile) rose substantially above short-run marginal cost in 2006.
- Economies of density and fixed costs require railroad pricing above short-run marginal cost to achieve revenue sufficiency.
- For most years in the 1987 to 2006 period of our study, the Class I railroad industry does not appear to be earning above normal profit.
- The increase in railroad rates experienced in recent years is the result of declining productivity growth and increased costs rather than the increased exercise of market power.
- Railroads use differential pricing to recover their total costs.
- Different commodity groups face different markups of railroad rates over marginal costs.
- Within commodity groups, shippers with no or very limited transportation options tend to pay higher rates than shippers with the same shipment characteristics who enjoy more or better transportation alternatives.
- The ratio of revenue to URCS variable cost (R/VC) is weakly correlated with market structure factors that affect shipper "captivity," and is not a reliable indicator of market dominance.
- Capacity "tightness" is primarily due to congestion at terminals or other specific network locations. Terminal congestion in the 2003-2005 period was linked to service performance declines during that time period.
- Current market circumstances imply that providing significant rate relief to certain groups of shippers will likely result in rate increases for other shippers or threaten railroad financial viability.
- Incremental policies such as reciprocal switching and terminal agreements have a greater likelihood of resolving shipper

concerns via competitive response, and have a lower risk of leading to adverse changes in industry structure, costs, and operations.

- Some shippers will not benefit from efforts to enhance railroad competition, implying the necessity of continued regulatory oversight.

While the GAO posed the question of whether recent performance of the U.S. freight railroad industry is indicative of "a possible abuse of market power," our analysis provides evidence on whether there has been a change in the exercise of market power by U.S. railroads. By definition, the setting of price above marginal cost is what economists consider to be an exercise of market power, but exercise does not imply abuse. To address the question of whether there has been an "abuse of market power" would require judgments as to the fairness of the distribution of value between the railroads and the shippers, and on the distribution of the overhead cost collection among the shippers. These judgments are policy questions and not resolvable through economic analysis alone. Instead, we have answered the economic questions of the extent to which recent railroad pricing behavior reflects changing cost conditions, and the extent to which it represents an increase in the overall exercise of market power. Furthermore, our analysis sheds light on how recent railroad pricing behavior has shifted the burden of overhead cost collection among the different sets of shippers.

ES1 CURRENT STATE OF COMPETITION IN U.S. FREIGHT RAILROAD INDUSTRY

Characteristics of U.S. Freight Railroad Traffic

Since 1980, railroads have been gaining an increasing share of U.S. freight shipments (see Table ES-1). According to data complied by the U.S. Department of Transportation, railroads accounted for about 27 percent of the ton-miles of U.S. freight moved in 1980. By 2005, the share of ton-miles attributed to railroads increased to about 38 percent.[6]

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[6] National Transportation Statistics 2008, U.S. Department of Transportation, Research and Innovative Technology Administration, Bureau of Transportation Statistics.

TABLE ES-1
TON-MILES OF FREIGHT BY MODE[7]

	1980	1985	1990	1995	2000	2005
Total	3,404,015	3,313,968	3,621,943	4,104,235	4,328,642	4,537,921
Air Carrier	4,840	6,710	10,420	12,720	15,810	15,731
Intercity Truck	629,675	716,808	848,779	1,034,041	1,192,825	1,293,326
Rail	932,000	876,209	1,064,408	1,317,010	1,546,319	1,733,777
Domestic Water	921,835	892,971	833,544	807,728	645,799	591,276
Pipeline	915,666	821,270	864,792	932,737	927,889	903,811
Rail Share	27%	26%	29%	32%	36%	38%

Table ES-2 indicates that a wide variety of commodities are transported by railroads.

TABLE ES-2
RAIL SHIPMENTS BY COMMODITY GROUPING, 2007[8]

	Tons Originated		Gross Revenue	
	(thousands)	percent	(millions)	percent
Coal	849,630	43.8%	$11,471	21.0%
Chemicals & allied products	177,612	9.2%	$6,885	12.6%
Farm products	152,242	7.8%	$4,529	8.3%
Non-metallic minerals	137,556	7.1%	$1,527	2.8%
Misc. mixed shipments*	124,531	6.4%	$7,863	14.4%
Food & kindred products	105,457	5.4%	$4,041	7.4%
Metallic ores	59,162	3.1%	$542	1.0%
Metals & allied products	57,046	2.9%	$2,353	4.3%
Petroleum & coke	56,262	2.9%	$1,797	3.3%
Stone, clay, & glass products	48,115	2.5%	$1,607	2.9%
Waste & scrap materials	48,034	2.5%	$1,276	2.3%
Lumber & wood products	36,152	1.9%	$1,987	3.6%
Pulp, paper, & allied products	35,269	1.8%	$2,100	3.8%
Motor vehicle equipment	31,682	1.6%	$4,016	7.3%
All other commodities	20,989	1.1%	$2,642	4.8%
Total	1,939,738	100.0%	$54,637	100.0%

* The misc. mixed shipments category consists primarily of intermodal shipments.

In terms of tons originated, coal represents, by far, the largest proportion of railroad shipments. Chemicals, farm products, non-metallic minerals, and miscellaneous mixed shipments are also relatively large categories in terms of tons originated. Examining the proportions of railroad gross revenues by commodity group, coal is still the largest category but, reflecting its low-value, bulk commodity status, does not stand out as much from the other commodity groups in terms of revenue as it does in terms of tonnage. The miscellaneous mixed shipments category, which consists primarily of intermodal shipments, represented only 6.4 percent of 2007 tons originated but accounted for 14.4 percent of railroad revenues.[9] This is a reflection of the high value of intermodal railroad services. Other categories that represent relatively large proportions of railroad revenues include chemicals, farm products, food, and motor vehicle equipment. While railroads play a key role in overall U.S. freight shipments, shippers of certain commodities are especially reliant on rail transportation. For example, the Association of American Railroads (AAR) reports that 70 percent of domestically produced automobiles,[10] 70 percent of coal delivered to power plants,[11] and about 35 percent of the U.S. grain harvest all move by rail.[12]

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[7] National Transportation Statistics 2008, U.S. Department of Transportation, Research and Innovative Technology Administration, Bureau of Transportation Statistics.

[8] Class I Railroad Statistics, Association of American Railroads, July 17, 2008.

Structure of U.S. Freight Railroad Industry

Consolidations in the railroad industry have reduced the number of Class I railroads from about forty around the time of the passage of the Staggers Act to the current seven.[13] While the number of Class I railroads has declined, the total number of railroads has increased from about 490 in the mid-1980s to the current 559.[14] The number of Class I railroad employees declined from over 450,000 in 1980 to 167,000 in 2007.[15] Non-Class I employment has declined in proportion to Class I employment reductions so that the percent of industry employment by non-Class I railroads has remained at approximately ten percent.

Regional and shortline railroads own and/or operate an increasing proportion of the nation's railroad infrastructure. Overall, both total miles of road owned and miles of road operated by all U.S. railroads have fallen between 1987 and 2006. However, both measures have fallen more sharply for Class I railroads than for all railroads in the U.S. Between

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[9] Class I Railroad Statistics, Association of American Railroads, July 17, 2008.

[10] "The Economic Impact of America's Freight Railroads," Association of American Railroads, August 2008, p. 2. The percentage reported here does not include imported automobiles transported by railroad from ports on both coasts.

[11] "Railroads and Coal," Association of American Railroads, July 2008, p. 3.

[12] "Railroads and Grain," Association of American Railroads, July 2008, p. 5.

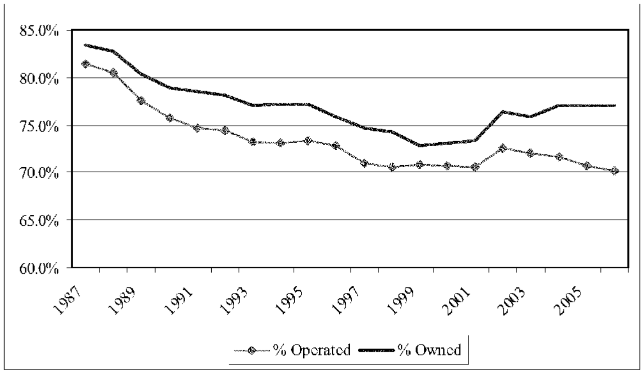
[13] "The Effects of Rail Mergers on the Number of Class I Railroads and Shipper Captivity," Association of American Railroads, August 2008, p. 1.

[14] "Railroad Ten-Year Trends," American Association of Railroads, Vol. 7, p. 10; and "Class I Railroad Statistics, 2007," Association of American Railroads.

[15] "Class I Railroad Statistics, 2007," Association of American Railroads; "Railroad Ten-Year Trends," Association of American Railroads, Vol. 7, p. 10.

1987 and 2006, miles of track operated declined by 18.9 percent for Class I railroads versus a decline of 5.9 percent for all U.S. railroads. Similarly, miles of track owned declined by 26.8 percent for Class I railroads versus a decline of 20.9 percent for all U.S. railroads over this period.[16] The proportions of total industry miles owned and miles operated by Class I railroads have fallen from over 80 percent of the industry totals in the 1980s to about 77 percent (owned) and 70 percent (operated) today, as the number of smaller railroads has increased significantly over this period. As Figure ES-1 shows, the decline has recently been greater for the Class I proportion of miles operated, reflecting spinoffs in the operation of Class I-owned trackage to other railroad classes.

FIGURE ES-1
CLASS I PROPORTIONS OF U.S. RAILROAD MILES OF TRACK OWNED AND OPERATED
1987-2006



While total Class I miles of track have declined, usage of that track has intensified as Class I revenue ton-miles have grown continuously over the study time period. Between 1987 and 1999, Class I net ton-miles grew by 51.5 percent, compared to a 19.9 percent decline in total track miles. Between 1999 and 2006, Class I net ton-miles grew by 23.1 percent, compared to a 1.7 percent decline in total track miles.[17]

The increasingly intensive use of Class I track miles is illustrated in Figure ES-2, which charts the Class I ratio of net ton-miles to total track miles. This increasingly intensive use of railroad networks results in lower per-unit costs—a reflection of economies of density.

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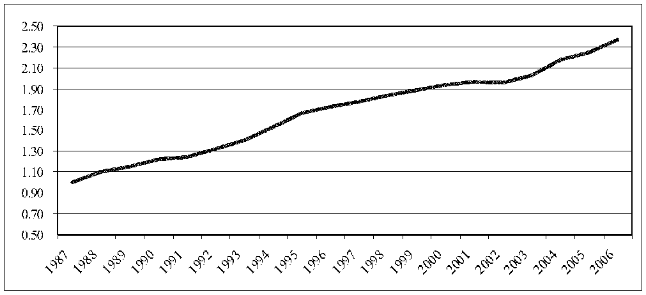
[16] "Railroad Ten-Year Trends," American Association of Railroads, Vol. 24, p. 10; "Class I Railroad Statistics, 2007," Association of American Railroads; and "Railroad Ten-Year Trends," American Association of Railroads, Vol. 7, p. 10. The reported values do not include data for Canadian railroads with U.S. operations.

[17] Net ton-mile data are from R-1 Annual Reports, Schedule 755, Line 114, Column B.

FIGURE ES-2
CLASS I RATIO OF NET TON-MILES TO TOTAL TRACK MILES
1987-2006



Assessment of Shipper Captivity

The analysis of shipper captivity in the 2006 GAO report includes the computation of shares of shipments generating revenues in excess of 180 percent and 300 percent of URCS variable cost, and discussion of changes in those shares over time. GAO presented its analysis in the context of the statutory role played by the 180 percent revenue/variable cost (R/VC) threshold in triggering rate reviews, and the limited availability of data to properly measure or serve as proxies for shipper captivity:

> Nevertheless, our analysis of available measures indicates that the extent of captivity appears to be dropping, but the percentage of industry traffic traveling at rates substantially over the statutory threshold for rate relief has increased. For example, the amount of traffic traveling at rates over 300 percent of the railroad's variable cost increased from 4 percent in 1985 to 6 percent in 2004. Furthermore, some areas with access to one Class I railroad have higher percentages of traffic traveling at rates that exceed the statutory threshold for rate relief.[18]

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[18] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed,* GAO-07-94, October 6, 2006, p. 3.

In Chapter 11, we examined 2000-2001 and 2005-2006 Carload Waybill Sample data and found that the fractions of tonnage and ton-miles exceeding 180 percent R/VC were relatively constant, but the fractions exceeding 300 percent R/VC increased. Our results are consistent with the direction of the GAO findings, though we obtained larger shares of high R/VC traffic for tonnage versus ton-miles (see Table ES-3). We also examined the shares of traffic traveling at rates less than 100 percent R/VC, which interestingly also increased slightly between the two periods.[19]

TABLE ES-3
PERCENT OF TONS AND TON-MILES BY R/VC CATEGORY
2000-2001 V. 2005-2006 CARLOAD WAYBILL SAMPLE DATA

	Percent of Tons by R/VC Category				
Period	**R/VC < 100 Percent**	**R/VC between 100 and 180 Percent**	**R/VC between 180 and 300 Percent**	**R/VC > 300 Percent**	**Subtotal R/VC > 180 Percent**
2000-2001	14%	44%	31%	12%	43%
2005-2006	14%	42%	27%	17%	44%

	Percent of Ton-Miles by R/VC Category				
Period	**R/VC < 100 Percent**	**R/VC between 100 and 180 Percent**	**R/VC between 180 and 300 Percent**	**R/VC > 300 Percent**	**Subtotal R/VC > 180 Percent**
2000-2001	19%	51%	25%	5%	30%
2005-2006	20%	51%	21%	9%	29%

R/VC Data Issues

In Chapter 11, we discussed two main issues with the R/VC data in the CWS that we believe make this ratio an unreliable indicator of market-dominant behavior. First, there is evidence of methodological changes that might materially affect the measured shares of shipments exceeding 180 percent R/VC. Second, captivity measures based on categorizing shipment-level R/VC (or markup) data are dependent on alignment of actual and measured costs, particularly for high values of R/VC, and this appears to be problematic.

R/VC ranges remain large even after aggregation over time and geography. For example, the county-level R/VC ratios for wheat shipments range from 43 percent to 757 percent. While substantial variation in actual R/VC is certainly possible, the R/VC variations are large relative to the estimated effects of the market structure factors in the pricing models. As we illustrate in Figures ES-3 and ES-4, the implication is that much of the R/VC variation is related to factors other than market structure features that determine shipper captivity.

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[19] For tons, a small increase is not evident in Table 18-3 due to rounding.

R/VC and Market Structure Factors

From an economic perspective, "relative captivity" arises for shippers whose next best alternatives do not effectively constrain railroad rates. The effects of captivity may be continuous and have no definite relationship to markup thresholds. For instance, a shipper may pay a rail rate under the 180 percent R/VC threshold and nevertheless experience a degree of "captivity" relative to other shippers with similar cost characteristics because other shippers have better access to intramodal or intermodal competition that results in lower rail rates. Conceptually, more appropriate measures of captivity should focus on the effects of the transportation market structure on rail rates—and, by extension, markups—rather than on markups as indicators, *per se,* of market-dominant behavior. In this regard, the GAO was justified in examining additional measures using information on market structure, such as rates and R/VC in areas without Class I railroad competition.[20]

Furthermore, the R/VC ratio does not appear to perform well as a proxy for conceptually more appropriate market structure measures. We find that R/VC is weakly related to measures of railroad and water competition. Table ES-4 shows correlations between county-level R/VC ratios and market structure factors for selected commodities.

TABLE ES-4
CORRELATIONS OF ORIGIN COUNTY* R/VC WITH REVENUE PER TON-MILE AND MARKET STRUCTURE FACTORS, 2001-2006 DATA, SELECTED COMMODITIES

	Correlation Coefficient with R/VC Ratio					
Commodity Group	**RPTM**	**Distance to Water (Origin)**	**Distance to Water (Destination)**	**Railroad Competition at Origin**	**Railroad Competition at Destination**	**Econometric Market Structure Shifter**
Chemicals	0.18	-0.03	-0.01	-0.07	0.01	0.06
Coal	0.61	-0.26	0.03	-0.25	-0.13	0.05
Corn	0.23	-0.01	0.09	0.00	-0.06	0.07
Intermodal	0.12	-0.06	0.13	-0.04	-0.20	0.21
Transportation	0.16	-0.18	-0.18	-0.05	-0.02	-0.10
Wheat	0.44	0.09	-0.04	-0.05	-0.02	0.08

* Note: Coal based on destination county data.

As reported in Chapter 12, our coal pricing models find evidence of strong competitive effects from railroad competition at the destination counties, but the correlation between county-level R/VC and our measure of destination competition is only -0.13.

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[20] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed,* GAO-07-94, October 6, 2006, p. 36.

Using wheat as an example, the correlation between R/VC and the distance to water at origin in Table ES-4 is only 0.09. Comparing Figures ES-3 and ES-4 reveals this lack of correlation. Figure ES-3 shows relatively high R/VC ratios in some areas implicated in wheat shippers' "captivity" complaints—notably, the far northern Plains—but not in other areas well-removed from water alternatives such as western Kansas. Figure ES-3 also shows high R/VC ratios in Pacific Northwest counties and other areas that would be expected to have better modal alternatives. The pricing models for wheat imply a strong effect of distance from the origin county to water transportation on wheat rates; that effect dominates the market structure effect as seen in Figure ES-4. These results are typical of the weak relationships between R/VC and market structure measures observed for other commodities.

FIGURE ES-3
R/VC AVERAGES BY ORIGIN COUNTY FOR WHEAT SHIPMENTS
2001-2006 CARLOAD WAYBILL SAMPLE

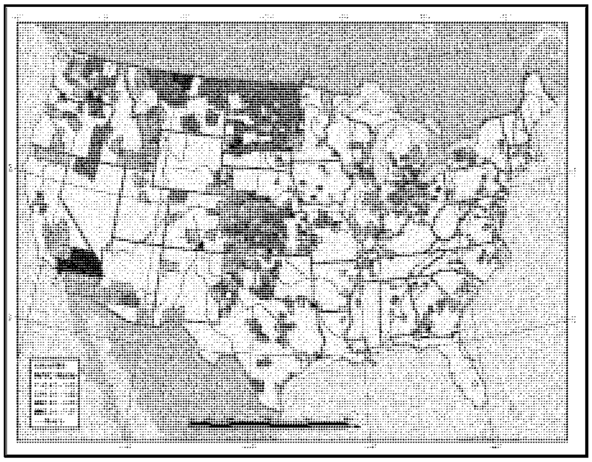
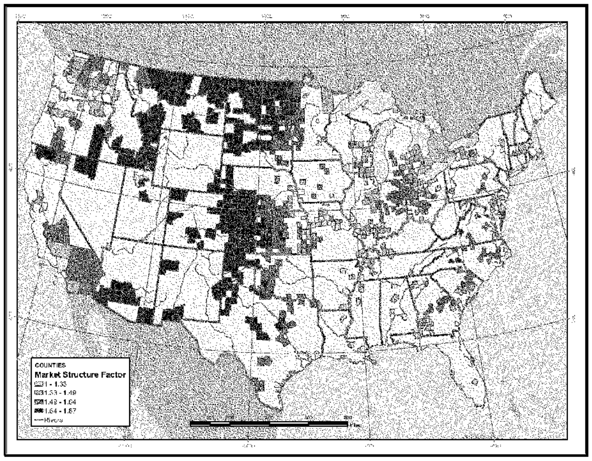


FIGURE ES-4
COUNTY-LEVEL EFFECTS OF MARKET STRUCTURE VARIABLES IN WHEAT PRICING MODELS ON REAL REVENUE PER TON-MILE



Evaluating "Captivity" and Market Structure Factors

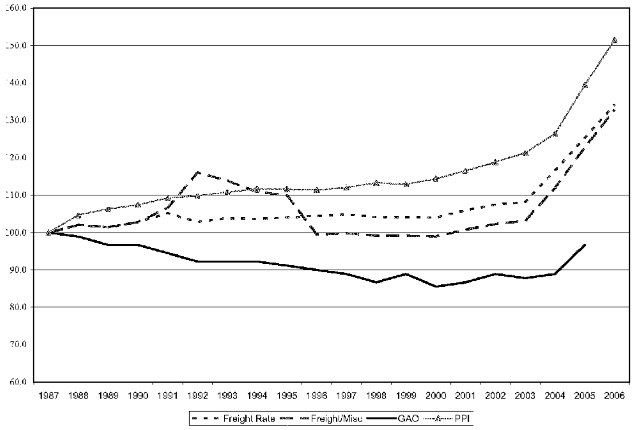
The R/VC ratio, applied prudently, may be able to identify categories of shipments that travel at high rates relative to costs, but the R/VC ratio is not very useful as an indicator of the presence of market structure factors that would increase a shipper's "captivity" to an individual railroad. The weak relationships between R/VC ratios and market structure factors illustrated in Table ES-4 imply that correctly assessing the presence of market-dominant behavior requires direct assessment of relevant market structure factors. Thus, regulatory reforms that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance are not appropriate.

In contrast, analyses of railroad rates (real revenue per ton-mile or RPTM) using data sources such as the CWS can indicate the effects of railroad and water competition factors on RPTM directly. These analyses permit us to identify market structure factors that have greater effects on RPTM by commodity, and also counties with combinations of market structure factors that will tend to increase a shipper's relative captivity.

Trends in Rates

While overall railroad prices were fairly stable-to-declining for a long period of time in the post-Staggers Act period, rates have increased substantially in the last few years. Figure ES-5 shows industry-wide rate indexes for the period 1987 through 2006. In addition to the industry-wide index constructed by the GAO, and the U.S. Bureau of Labor Statistics' Producer Price Index, we constructed two rate indexes from information contained in the Carload Waybill Sample. As described in Chapter 8, these two indexes are designed to address some of the conceptual weaknesses that have previously been attributed to the GAO index and the Producer Price Index. Because the GAO noted that there had been a substantial increase in miscellaneous charges in recent years, which may reflect fuel surcharge billings, we constructed one index based on freight revenues reported in the Carload Waybill Sample ("Freight Rate"), and a second index based on total revenue (including miscellaneous charges – "Freight/Misc"). The indexes that we constructed showed very little overall price growth between 1987 and 2003, but, these rate indexes showed increases exceeding seven percent per year (in nominal dollars) between 2003 and 2006. The four reported rate indexes represent overall trends for the railroad industry, but do not reflect significant differences that exist among the rates paid by different commodities. Chapter 8 (among several other chapters in Volume 2) provides more detail on rate changes by commodity.

FIGURE ES-5
INDUSTRY-WIDE INDEXES CONSTRUCTED FROM CARLOAD WAYBILL SAMPLE
1987 = 100



Trends in Input Prices and Productivity

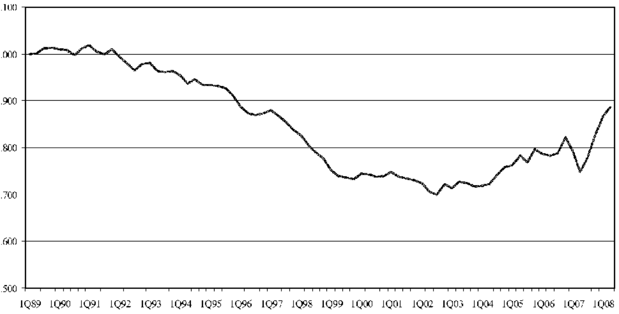
As illustrated in Figure ES-5 above, since the early 2000s, rates generally began to go up, creating questions about the exercise of market power in the increasingly concentrated railroad industry.[21] Much of the observed increase in rail rates can be explained by examining railroad industry input prices and productivity growth.

The STB's rail cost adjustment factor, unadjusted for productivity gains (RCAF-U) represents trends in railroad input prices. It is based on the All-Inclusive Index for Class I railroads, maintained by the Association of American Railroads (AAR). The All-Inclusive Index measures price changes for the major components of the railroad industry's operating expenses—labor, fuel, materials and supplies, equipment rents, depreciation, interest, and other expenses. The second element of the STB's RCAF methodology is the productivity adjustment factor (PAF), which represents trends in output per unit of input. The final element of this methodology is the productivity-adjusted rail cost adjustment factor (RCAF-A), which is obtained by dividing the RCAF-U by the PAF. By construction, RCAF-A measures trends in the railroad industry's unit costs, as it represents the difference between input price growth and productivity growth.

Figure ES-6 shows the quarterly RCAF-A from the Quarter 1 of 1989 through the Quarter 2 of 2008.

FIGURE ES-6
RCAF-A, 1989-2008

(1Q89=1.000)



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[21] For example, see Government Accountability Office, *Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006, pp. 11-15.

The RCAF-A series illustrates the net impact of input price increases and productivity increases on the railroad industry's unit costs. As detailed in Chapter 8, in recent years railroad input price growth has generally increased across most categories (not only fuel) and, at the same time, industry productivity growth has slowed. Thus, overall railroad unit costs, measured by RCAF-A have gone up in recent years after reaching a minimum in Quarter 3 of 2002.

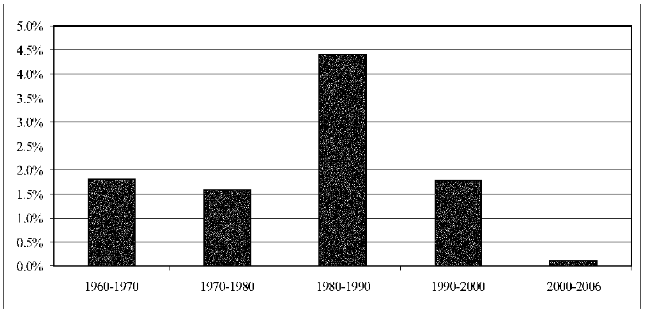
Table ES-5 provides details on the sources of railroad input price growth. It shows the average annual rates of nominal input price growth for labor, fuel, materials and services, equipment rents, depreciation, interest, and other expenses between Quarter 1 of 1994 (the first instance RCAF-U component detail was available) and Quarter 2 of 2008. This table also shows the average annual rates of input price growth for two sub-periods, Quarter 1 of 1994 to Quarter 3 of 2002 (when RCAF-A reached a minimum) and Quarter 3 of 2002 to Quarter 2 of 2008. The table illustrates that the increase in fuel costs has been much greater in the second sub-period. However, with the exception of interest (which has only a cost weight of 2.7 percent in the 2008 RCAF-U), all other railroad input prices grew faster in the second sub-period than in the first sub-period.

TABLE ES-5
GROWTH IN RCAF-U COMPONENTS
AVERAGE ANNUAL GROWTH IN PRICES, 1994Q1-2008Q2

	1Q94-2Q08	1Q94-3Q02	3Q02-2Q08	1Q00-2Q08
Labor	2.8%	2.4%	3.5%	3.0%
Fuel	11.4%	3.2%	23.9%	15.9%
M&S	3.2%	0.6%	7.0%	5.1%
Equip. Rents	1.3%	1.0%	1.8%	1.5%
Depreciation	2.3%	0.7%	4.8%	3.2%
Interest	-2.8%	-2.5%	-3.3%	-1.0%
Other	2.1%	1.0%	3.8%	2.7%
RCAF-U	3.4%	1.5%	6.3%	4.5%

The productivity trends in the STB's PAF measure generally follow railroad industry productivity trends measured by the U.S. Bureau of Labor Statistics (BLS). The BLS maintains a multifactor productivity (MFP) index for the railroad industry, which extends back to 1959 (PAF is available only back to 1989). The MFP index for railroads shows that while productivity increased during the pre-Staggers era, there was a substantial increase in railroad productivity growth during the 1980s and into the 1990s. Beginning in the 1990s, the rate of productivity growth began to decrease (i.e., productivity growth was less rapid) ,to the point where productivity growth between 2003 and 2006 was below that achieved during the pre-Staggers era. Figure ES-7 shows the average differential between railroad productivity growth and the productivity growth in the private business sector of the U.S. economy by decade. Railroad productivity growth was much more rapid than the productivity growth in the U.S. private business sector up until 2000, but since 2000 the railroad industry and the U.S. private business sector have had very similar rates of productivity growth.

FIGURE ES-7
MFP GROWTH DIFFERENTIAL: RAILROAD INDUSTRY V. PRIVATE BUSINESS SECTOR



Both the STB and BLS measures of the railroad industry's productivity confirm a slowdown in industry productivity growth in this decade. One effect of this slowing productivity growth is a diminished ability of railroads to absorb increases in their input prices in recent years.

Trends in Economic Costs

Figure ES-8 provides information on Class I annual average total cost of shipping a ton-mile (ATC), as well as its components, average variable cost (AVC) and average fixed cost (AFC), based on R-1 data. With the exception of 1991, ATC and AVC declined over the 1987-1996 period. ATC and AVC increased between 1997 and 2000, and held roughly constant from 2001 to 2003. ATC then increased substantially in 2004 and 2005, but declined slightly in 2006. AVC increased each year 2004-2006. AFC held constant through 1994 and then increased modestly through 2003. More recently, AFC has increased substantially in 2004 and 2005, as is consistent with the explanation of major road enhancements occurring over the 2004-2006 period.[22]

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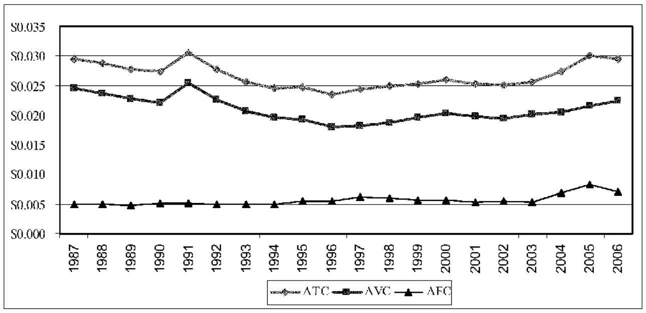
[22] AFC decreased in 2006 from its peak in 2005, but its level remained high.

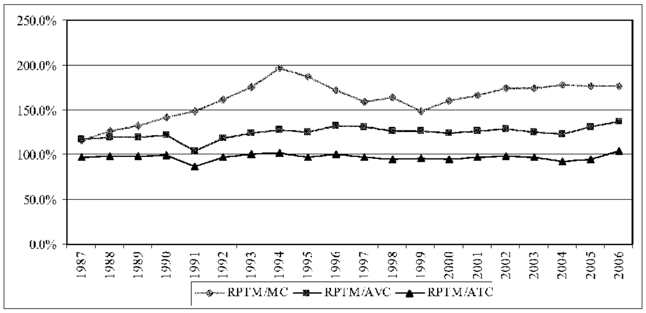
FIGURE ES-8
CLASS I AVERAGE TOTAL COST, AVERAGE VARIABLE COST, AND AVERAGE FIXED COST
(YEAR 2000 DOLLARS)



If the recent increases in AVC and AFC are transitory, due to construction projects, then ATC should decline substantially as the construction projects are completed and as traffic volume and speed increase. If, however, the recent increases are permanent or reflective of changing shipment mix, then average total cost and the rates required to obtain revenue adequacy will remain at higher levels.

Figure ES-9 presents three different markup ratios for the Class I railroad industry. The top series shows the ratio of the average revenue per ton-mile to marginal cost (RPTM/MC). This ratio reflects the extent to which market power is being exercised in the railroad industry. By definition, the setting of price above marginal cost is the exercise of market power, but exercise does not imply abuse. The industry gained market power (i.e., increasing RPTM/MC ratio) primarily during the periods of marginal cost decreases, ceded some of that market power during the periods of cost increases associated with the large mergers, and maintained market power in the recent period of cost increases. The industry-wide RPTM/MC ratio peaked at 196 percent in 1994 and has stabilized in recent years around 175 percent.

Figure ES-9
Class I Industry Markup Ratios



The second series in Figure ES-9 displays the revenue per ton-mile to average variable cost ratio (RPTM/AVC). This ratio is conceptually equivalent to the revenue to variable cost ratio (R/VC) that is a threshold measure of market dominance in captive shipper rate cases. The RPTM/AVC ratio has gradually increased from 117 percent to 137 percent over the twenty-year study period. Interestingly, we note that the industry-wide RPTM/AVC measure remains well below the 180 percent R/VC threshold used by the STB in captive shipper rate cases. We further note that the RPTM/AVC ratio does not track very well with the market power indicator of RPTM/MC. This lack of correspondence may be indicative of the weakness of the R/VC measure as an indicator of market power abuse.[23]

The third series in Figure ES-9 shows the revenue per ton-mile to average total cost ratio (RPTM/ATC). This graph conveys the information about *revenue sufficiency* for the overall industry. Values of the RPTM/ATC ratio greater than or equal to 100 percent indicate that revenues are greater than or equal to total costs, while values less than 100 percent imply that revenues are insufficient to cover total costs. The graph, based on R-1 data, shows that the industry has remained close to being revenue adequate for most years in our study, but more often than not it has fallen short.

Figure ES-10 changes the vertical scale to focus on the RPTM/ATC ratio for the Class I railroad industry. As noted above, this ratio is a measure of industry revenue sufficiency (indicated by

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[23] We are not suggesting that the aggregate average rate to the aggregate average variable cost ratio presented in Figure ES-9 is the appropriate R/VC measure for rate cases. The R/VC measure used in rate cases is market-, shipper-, railroad-, and route-specific. We further note that the R/VC measure is based on the Uniform Rail Costing System (URCS), while our RPTM/AVC ratio is based on R-1 data.

RPTM/ATC = 100 percent). It can be seen that the industry has flirted with revenue sufficiency for a number of years, but has only achieved or surpassed it a few times in the mid-1990s and in 2006 (1993 = 100.0%, 1994 = 101.7%, 1996 = 100.0%, 2006 =104.1%).[24] Furthermore, the 2006 value of RPTM/ATC was preceded by a sizeable drop in 2004, which was the RPTM/ATC ratio's lowest point since 1991.

FIGURE ES-10
CLASS I INDUSTRY RATIO OF AVERAGE RPTM TO AVERAGE TOTAL COST

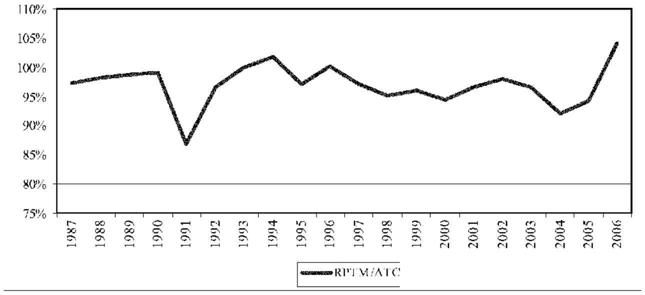

Figure ES-11 displays the Lerner Index for the Class I railroad industry.[25] It shows that between 1987 and 1994, pricing power steadily increased. However, the industry was still below revenue sufficiency during most of this period until 1994 (see Figure ES-10). Thus, the rapidly-increasing LMI does not indicate that market power has been exercised by railroads with resulting excess profits, but rather indicates a movement toward revenue sufficiency. As detailed in Chapter 10, from 1995 to 1999, the LMI generally decreased with increasing marginal costs.. Between 2000 and 2003, there was some recovery of the industry's pricing power, largely resulting from declining marginal costs as documented in Chapter 10. Again, however, viewing these results in the context of revenue sufficiency, this run-up in the LMI does not correspond to railroads achieving excessive levels of profit. Since 2003, the LMI has remained relatively constant as prices and marginal costs have moved in parallel—i.e., price increases since 2003 have largely matched marginal cost increases.

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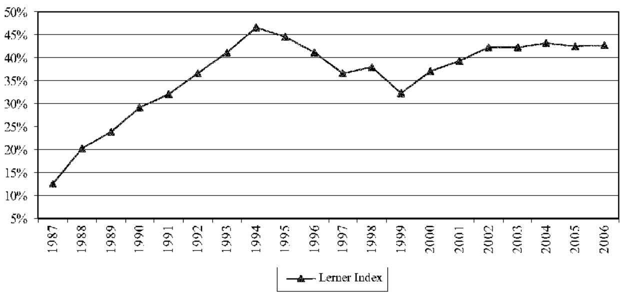
[24] We note that the measures of costs that we develop from the R-1 data do not include any current assets, such as cash. Furthermore, our calculations are based on some variables defined for the econometric analysis undertaken in Chapter 9 and may not conform to a conventional financial analysis. Thus, the ratio of revenue to cost presented in Figure ES-10 is revealing, but should not be viewed as the definitive indicator of revenue sufficiency. Also, as reported in Chapter 10, when the railroads are examined individually, we find that BNSF and NS each had thirteen of twenty years where the R-1 reported revenues matched or exceeded costs, UP had eight of twenty years with revenues greater than or equal to costs, and CSX had only three revenue-sufficient years in the time frame of our analysis.

[25] The Lerner Index is defined as the ratio of the difference between price and marginal cost to the price, which in this case is equal to (RPTM – MC) / RPTM. As discussed in Chapter 10, the Lerner Index is a measure of market power. The Lerner Index is also known as the Lerner Markup Index or the Lerner Market Power Index, and it is sometimes abbreviated as LMI in this report and elsewhere in the literature.

FIGURE ES-11
RAILROAD INDUSTRY LERNER MARKUP INDEX



Economies of Density and Differential Pricing by Commodity

Economies of density arise when the average cost of serving customers decreases as the volume of business increases over a network. When economies of density are present, marginal cost pricing does not produce enough revenue to cover a firm's total cost, and alternative pricing or funding mechanisms must be found. Differential pricing (i.e., charging different price markups over marginal costs to different customers or customer classes) is recognized in the economic literature as a pricing method that might be used to achieve revenue sufficiency in the presence of economies of density.

As is the case with other network industries, the railroad industry engages in differential pricing, where different customer groups face different levels of price markups over marginal costs. Since the passage of the Staggers Act, freight rail transportation rates have been largely deregulated, as discussed in Chapter 20, with the Surface Transportation Board providing a regulatory backstop for captive shippers. As the quotation below illustrates, differential pricing is acknowledged by policy as a method by which railroads achieve revenue adequacy, with the STB determining whether the degree of differential pricing is reasonable if a rate is challenged.

> When there is a challenge to the reasonableness of a rail rate charged for captive traffic, [the STB's] regulatory task is to determine whether the degree of differential pricing--i.e., the amount by which the revenues derived from the traffic at issue exceed the long-run marginal cost (LRMC) of handling the traffic—is reasonable.[26]

Table ES-6 shows the estimated median-adjusted marginal costs and markups (LMIs) by commodity for the 2001-2003 and 2004-2006 periods.

TABLE ES-6
ESTIMATED MEDIAN-ADJUSTED MARGINALCOSTS AND MARKUPS,
2001-2003 AND 2004-2006CLASS I RAILROADS

	LMI		Adjusted MC (2000 Q1 cents)	
Commodity	**2001-2003**	**2004-2006**	**2001-2003**	**2004-2006**
Farm Products (Aggregate)	0.61	0.61	0.9	0.9
Barley	0.68	0.75	0.7	0.6
Corn	0.71	0.73	0.7	0.6
Wheat	0.67	0.71	0.8	0.7
Soybeans	0.63	0.58	0.9	1.0
Metallic Ores	0.46	0.51	2.1	2.3
Coal	0.41	0.41	1.1	1.1
Non-metallic Minerals	0.52	0.39	1.8	2.2
Food Products	0.59	0.60	1.2	1.2
Lumber & Wood Products	0.64	0.63	1.4	1.4
Chemicals	0.63	0.59	1.6	1.6
Petroleum & Coal Products	0.64	0.60	1.6	1.5
Clay, Concrete, Glass, & Stone	0.60	0.60	1.7	1.8
Primary Metal Products	0.59	0.59	1.8	2.1
Transportation Equipment	0.55	0.51	5.1	5.4
Intermodal (COFC/TOFC)	-0.36	-0.35	4.3	4.5

The marginal cost and markup estimates presented in Table ES-6 provide an indication of whether recent rate increases have been mainly cost-driven or markup-driven. With respect to marginal costs, it shows that despite the industry-wide increase in marginal costs in 2004-2006 (see Chapter 10), different patterns appear across the listed commodities. Some shippers apparently were able to avoid, to some extent, the "generic"[27] increases in costs by adopting lower-cost shipment characteristics. For example, we observe that average car loadings and length of haul increased materially for coal shipments between the 2001-2003 and 2004-2006 periods, partly due to the increasing share of Powder River Basin coal in total coal shipments. These cost-saving changes in shipment characteristics for coal helped to offset the generic increase in marginal cost per ton-mile in the latter period. Thus, the adjusted marginal costs for coal are relatively constant across the two periods; the adjusted marginal cost would have been higher in the latter period without the cost-reducing changes in coal shipment characteristics. However, the data presented in Table ES-6 do not reflect any adjustment costs that coal shippers (or other shippers for that matter) may have incurred in adopting lower-cost shipment characteristics. In contrast, shipments of non-metallic minerals and primary metal products did not exhibit substantial cost-saving changes in their tons per car and length-of-haul characteristics between the two periods; with little offset from shipment-characteristic changes, the estimated marginal costs for these two commodity groups increased in the latter period.

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[26] *Rate Guidelines—Non-Coal Proceedings*, Ex Parte No. 347 (Sub-No. 2) (STB served December 31, 1996), p. 4.

We believe that our negative LMI estimates for intermodal shipments are anomalies resulting from data limitations for intermodal shipment characteristics in the CWS dataset. Intermodal shipments have some low-cost characteristics that are not included in the CWS dataset and therefore cannot be incorporated in our estimated pricing models and adjusted marginal cost calculations. Intermodal shipments are billed and recorded as single-carload shipments, but tend to travel long distances as a unit, thereby avoiding substantial switching and classification costs typical of non-intermodal, single-carload shipments. Additional data on intermodal shipments, including service characteristics, would produce more accurate estimates of the actual markups for intermodal shipments. Since intermodal shipments represent a large share of the railroad industry's revenues, improved data collection on these shipments is highly desirable. We expect that with better information on intermodal shipments' actual costs our pricing models would yield positive estimated markups for intermodal shipments, but still relatively low markups compared to other commodities.

The estimated LMIs are unchanged or declining from 2001-2003 to 2004-2006 for 10 of the 16 commodity groups. Three of the LMI increases are for grains that already had high estimated markups. The flat or declining LMIs for major commodity groups are consistent with the findings from Chapter 10 that railroads' exercise of market power tends to increase in periods of declining marginal cost. With the exceptions noted above, our estimates suggest pass-through of costs or some margin reductions when marginal costs are increasing.[28]

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[27] We use the term "generic" to refer to industry-wide increases across commodities.

It should be noted that the relatively constant or declining LMIs for commodities other than grains do not reflect constant shipment characteristics. In our qualitative research phase, we heard from shippers (particularly coal shippers) who noted that long-term, low-priced rail contracts had expired in this time frame and were replaced by higher-priced contracts or tariff rates. Such changes increase incentives for shippers to form shipments with lower-cost characteristics to partly offset the less favorable terms. We observe material shifts to lower-cost characteristics for various commodities in the CWS data, suggesting that shippers as a whole have some ability to substitute less costly shipment characteristics. However, shippers who are unable to adjust their shipping practices towards lower-cost characteristics may face substantial rate increases in periods of increasing industry costs.

From our analysis of particular commodity groups, we find generally expected effects on rail rates from increasing railroad competition at the origin and from increasing the distance from the origin to the nearest available water transportation. That is, rates generally tend to be lower given increased competition from other railroads or from increased proximity to water transportation alternatives at the origin, and higher for shippers with more limited railroad and water options at the origin. However, the existence of competitive responses is double-edged. Such responses illustrate the extent to which shippers who lack railroad or intermodal alternatives are at least relatively “captive” and pay higher rates (which may or may not exceed quantitative markup thresholds for market-dominance tests) for shipments with the same cost characteristics as those of more favorably situated shippers. Furthermore, in situations where other modes of transportation, such as water (and not potential railroad competition), provide the effective constraint on rail rates, policies to enhance railroad competition will not benefit captive shippers.

The result that shippers with fewer transportation alternatives pay higher rates is not unexpected in light of our findings from the industry-wide variable cost model of Chapter 9 and the constrained market-dominance model of Chapter 11. Railroads’ economies of density imply that they must implement positive markups over marginal cost per ton-mile, on average, in order to cover their total variable and “quasi-fixed” costs. Employing such local market power as is available is one means by which railroads achieve “revenue adequacy.”

From Chapters 11 through 15, our results with respect to a single railroad serving the origin county indicate that rail rates are commonly higher than they would be in the presence of even very limited railroad competition. Railroads appear to exercise some degree of local market power where possible, but are tempered by the prospect that large markups may elicit regulatory attention if not direct intervention. That is, monopoly railroads may effectively cede some market power to avoid regulatory scrutiny.

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[28] Long-term contracts may contribute to the stickiness of rates to the extent that they do not allow for the pass-through of railroad cost increases to shippers.

Financial Viability

By nearly all measures, the performance of the railroad industry has improved dramatically since the passage of the Staggers Act. The 2006 GAO report notes that "[t]here is widespread consensus that the freight rail industry had benefited from the Staggers Rail Act," and that "[f]reight railroads' improved financial health is illustrated by a general increase in return on investment since 1980, ..."[29]

The results of our econometric analysis of the railroad industry's revenue sufficiency are generally consistent with the benchmarking of railroad financial performance we performed in Chapter 8. We examined the railroad industry's earnings relative to the STB's determination of the industry's cost of equity and also relative to the earnings of benchmark industries. Regarding the comparison to the STB's determination of the cost of equity, we note that there was controversy surrounding the CAPM methodology recently adopted by the STB for determining a railroad's cost of equity.[30] Recognizing this controversy, a comparison of return on shareholders' equity for railroads to the STB's CAPM measure of the cost of equity for railroads, shows returns in excess of the cost of equity from 2000 through 2005 (with variation by individual railroad). However, using the STB's previous DCF method shows that railroads did not earn their cost of capital over the period of analysis (1997 to 2005). Given the methodological controversies and the divergence of these results, our assessment is that it is difficult to draw conclusions about whether the railroad industry has generated excessive profits, particularly when earlier observations using either the DCF or the CAPM methodology had shown the opposite result.

Although the railroad industry's earnings have increased in recent years, they do not appear to be excessive from a financial market perspective. Among the financial metrics we examined, one commonly cited financial measure is earnings per share (EPS). We found that over our analysis period, 1997 to 2006, there were many similarities among the financial performances of the railroad industry, the electric utilities industry, and the S&P 500 composite. Figure ES-12 shows that, in the last few years, the upward trend in the railroad industry's EPS is somewhat greater than the trend shown for the S&P 500 composite.[31]

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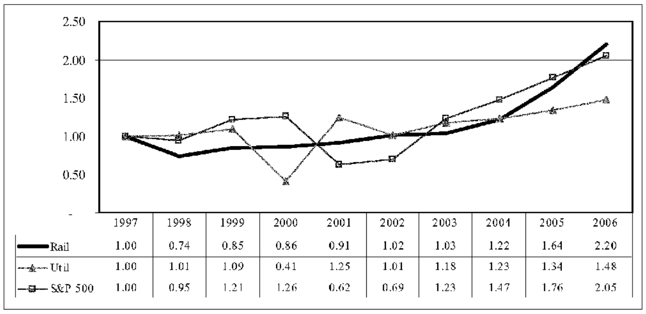
[29] Government Accountability Office, *Freight Railroads Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006, p. 9. We provide a more complete discussion of the railroad industry's financial performance in Chapter 8.

[30] For example, see Petition of the Association of American Railroads to Institute a Rulemaking Proceeding to Adopt a Replacement Cost Methodology to Determine Railroad Revenue Adequacy, May 1, 2008.

FIGURE ES-12
EARNINGS PER SHARE
1997-2006



	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Rail	1.00	0.74	0.85	0.86	0.91	1.02	1.03	1.22	1.64	2.20
Util	1.00	1.01	1.09	0.41	1.25	1.01	1.18	1.23	1.34	1.48
S&P 500	1.00	0.95	1.21	1.26	0.62	0.69	1.23	1.47	1.76	2.05

ES2 CURRENT AND NEAR-FUTURE CAPACITY CONSTRAINTS

A railroad's capacity can be generally thought of as anything that affects a railroad's ability to transport shipments (in a given amount of time) over its network. Thus, capacity is analogous to the factors affecting throughput in a communications or data network. From a physical inputs perspective, factors that affect a railroad's ability to transport shipments generally depend on the amount of capital (e.g., way and structures, railcars, locomotives, and signaling systems) and labor of various skill levels employed by the railroad. The amount of effective capacity available to provide services from a given quantity of production inputs (i.e., productivity) will be affected by factors such as technological innovations (often embodied in capital), work rules and other regulations, railroad operating practices, and learning by doing. The railroad's ability to adjust capacity depends on its ability to adjust these various types of capital and labor inputs as well as other attributes, with some more easily adjusted than others.

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[31] The electric utilities and railroad industries showed very similar EPS growth between 1997 and 2004.

A very important influence on a railroad's capacity is the existence of congestion at points in its network. In fact, while other measures of capacity along a given route may indicate sufficient capacity to meet demand, congestion at terminals, ports, highly congested urban areas, or other specific network locations is often a binding constraint on the utilization of route or network capacity.[32] Moreover, congestion at these localized points often affects network-wide performance. This is similar to the effects of blocking or congestion in other types of networks. For example, congestion at specific points in communications and data networks caused by capacity limits in switches or routers creates a restriction in network throughput despite the virtually unlimited capacity of fiber optic cable.

In Chapter 16 we conclude that, from numerous perspectives, there currently do not appear to be global or network-wide rail capacity constraints. Rather, as often occurs in network industries, congestion at various points or corridors in railroad networks appears to be the major culprit in capacity-related performance issues over the last ten years.[33] From a network-wide perspective, as discussed above, Class I total track mileage has stabilized over the last ten years, and the usage of track has become more intense as ton-miles per mile of track has grown continuously. Other studies have found that rail corridors are generally not constrained and our econometric results indicate that, in the aggregate, excess way and structures capacity exists. However, while such results can eliminate potential reasons for network congestion, congestion at terminals or other specific network locations is often a binding constraint on the utilization of route capacity or network-wide capacity. For example, we found increases in terminal congestion (with each Class I railroad having specific terminals that were particularly affected) in the 2003-2005 period were linked to service performance issues during that time period.

In September of 2007, Cambridge Systematics published a study sponsored by the Association of American Railroads on railroad infrastructure needs.[34] This study shows few current problems with available freight railroad infrastructure capacity as 88 percent of corridor mileage is below capacity, and less than one percent is above capacity. Our Class I industry variable cost function results from Chapter 9 (and also reported in Chapter 16) show that the industry as a whole still has an excess amount of way and structures capital. These results are consistent

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[32] James McClellan, "Railroad Capacity Issues," in *Research to Enhance Rail Network Performance,* Transportation Research Board, 2007, p. 32.

[33] The investigation of railroad network congestion is limited, to some extent, by data availability. As we indicate below, Burton has developed a promising approach to evaluate the need for additional investment at particular network locations.

[34] Cambridge Systematics, *National Rail Freight Infrastructure Capacity and Investment Study*, prepared for the Association of American Railroads, September 2007.

with the conclusion reached by a number of economic researchers that the railroad industry still has a considerable amount of overall excess capacity,[35] and the Cambridge Systematics study that concludes there presently is more than adequate capacity on most railroad network corridors. It is important to note, however, that these studies do not imply or conclude that there are no localized capacity shortages or choke points on individual segments of a railroad's network.

The result that railroads do not suffer from an overall capacity shortage (despite localized constraints) is not surprising given the "lumpiness" of most railroad capital investments. As noted in Chapter 3, network industries, including the railroad industry, often are capital-intensive and need to make capital investments in large increments. Furthermore, once these investments are made the capital is either costly to remove or its resale value is small. For these reasons, the amount of capital being used at any one time will not necessarily be at its optimal level, resulting in either an excess or shortage of capacity.

Regarding congestion at localized points in railroad networks, we examined the terminal dwell time data in the Railroad Performance Measures (RPM) dataset.[36] The RPM data indicate that, while each railroad has a somewhat unique pattern, one similarity that stands out is a general increase in terminal dwell times in the 2003-2004 period, followed by a decline in dwell times in 2005. The general increase in terminal dwell times during the mid-2000s indicates greater congestion at particular points in the railroad networks. Moreover, individual terminals differed considerably in the variability of their dwell times, suggesting that those terminals with the longest dwell times and largest variability might be affected by capacity constraints. Other descriptive measures indicate that the late 1990s and early 2000s witnessed declines in the railcar fleet, offset by greater railcar capacity, and increases in locomotive units and horsepower.

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[35] For example, see Ann F. Friedlaender, Ernst R. Berndt, Judy Shaw-Er Wang Chiang, Mark Showalter, and Christopher A. Vellturo, "Rail Costs and Capital Adjustments in a Quasi-Regulated Environment," *Journal of Transport Economics and Policy*, May 1993, pp. 131-152; and John D. Bitzan and Theodore Keeler, "Economics of Density and Regulatory Change in the U.S. Railroad Freight Industry," *Journal of Law and Economics*, February 2007, pp. 157-179.

[36] Association of American Railroads, at http://www.railroadpm.org/Definitions.aspx:

> Terminal Dwell is the average time a car resides at the specified terminal location expressed in hours. The measurement begins with a customer release, received interchange, or train arrival event and ends with a customer placement (actual or constructive), delivered or offered in interchange, or train departure event. Cars that move through a terminal on a run-through train are excluded, as are stored, bad ordered, and maintenance of way cars.

Chapter 16 notes some limitations of the RPM terminal dwell time data.

A recent study by the Rand Corporation noted that, in order to determine capacity needs at particular points of the network, much more detailed information on the network is required than what is currently publicly available.[37] Burton developed a promising approach to evaluate the need for and cost of additional railroad capacity at particular points of the railroad network.[38] His approach is based on a statistical analysis of railroad traffic levels on particular route segments and the characteristics of those route segments. Using a cross-section of route segments, he developed an econometric model that can be used to predict the available capacity on different network segments based on observed traffic data.

Regarding future capacity constraints, we concluded that recent increases in railroad capital spending, combined with a relatively weak economy, indicate that any capacity tightness that may have existed at the beginning of this decade has likely loosened in recent years. Thus, with the caveat that congestion issues are likely to continue to exist at localized points and cause service performance issues, near-term system wide railroad capacity constraints are not likely to be a major issue. Regarding the longer-term forecasts of capacity constraints, we concluded that forecasting capacity needs thirty years into the future (as is done in the Cambridge Systematics study) is difficult, at best, and is very sensitive to projections of future economic activity. Thus, it is our assessment that one must treat these forecasts of future capacity needs as tentative, at best, particularly given the current economic climate the U.S.

ES3 CAPACITY INVESTMENT

As discussed above, our analysis of railroad capacity indicates that while there is currently no systematic shortage of capacity in the railroad industry, there is evidence of localized capacity problems at various points in the rail network. Although the Cambridge Systematics study concluded that infrastructure investment of $148 billion (in 2007 dollars) would be needed to keep pace with projected economic growth in the United States along with the U.S. Department of Transportation's forecasts for railroad transportation demand, this study also showed that there currently are very few capacity problems in the rail network. Furthermore, this study's projected infrastructure investment requirement was based on a thirty-year forecast of railroad transportation demand. Over the thirty-year forecast period, if actual demand for freight railroad transportation matches the forecast, and if there are no additions to railroad capacity during the intervening time period, 30 percent of rail corridor mileage will be above capacity, while only 44 percent will be below capacity. Forecasting rail capacity needs thirty years into the future is, at best, a difficult project, and the conclusions of the Cambridge Systematics study are sensitive to the economic projections that drive freight commodity flow forecasts, future decisions about plant locations, availability of other transportation modes, and changes in business operations.

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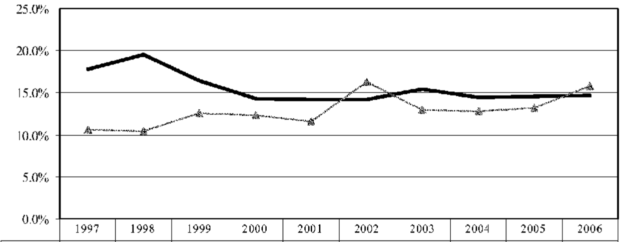
[37] Brian A. Weatherford, Henry H. Willis, and David S. Ortiz, *Infrastructure, Safety, and Environment: A Review of Capacity and Performance Data*, Rand Corporation, 2008, p. xii.

[38] Mark I. Burton, "Measuring the Cost of Incremental Railroad Capacity: A GIS Approach," http://www.njrati.org/files/research/papers/adobe/TPUG-01.pdf.

Our analysis in Chapter 10 also indicates that in the aggregate the value of investments in railroad infrastructure is less than the current price of those investments. Thus, while investment opportunities on certain nodes or links may pass an economic benefit-cost test, there do not appear to be strong economic incentives for the railroad industry to make global or extensive infrastructure investments at this time. Our analysis in Chapter 8 also indicates that the railroad industry's capital spending has remained a near-constant share of its revenue. This is similar to the pattern in the electric utilities industry, which is an industry similar to railroads in terms of infrastructure needs.

In Chapter 8, we compare the railroad industry's capital spending patterns to the benchmark industries we examined.[39] With the exceptions of 2002 and 2006, the railroad industry had the highest shares of its revenues devoted to capital spending. Figure ES-13 presents data on the capital spending to revenue ratios for the railroad and the electric utilities industries. This figure shows that the gap between the railroad and electric utilities industries considerably narrowed over time.

FIGURE ES-13
CAPITAL SPENDING/REVENUE
1997-2006



	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Rail	17.8%	19.6%	16.4%	14.3%	14.2%	14.1%	15.4%	14.4%	14.6%	14.7%
Util	10.6%	10.5%	12.6%	12.3%	11.5%	16.3%	13.0%	12.8%	13.2%	15.8%

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[39] The benchmark industries are electric utilities, freight transportation, food processing, and chemicals.

While railroad investment has increased in both real and nominal terms in recent years,[40] there has been no increase in the railroad industry's capital spending to revenue ratio induced by higher profits. One perspective is that, after a period of unusual activity, financial metrics reflect that the railroad industry is settling into a rate of capital expenditures that allows for maintenance and slow, steady growth.[41]

Railroad infrastructure may provide some public benefits that could potentially be addressed through targeted incentives. Investment in railroad infrastructure may provide an attractive transportation alternative to some shippers who currently rely on truck transportation for their shipping needs. Moving more truck transportation to rail would relieve highway congestion and reduce pollution. But these benefits will not influence a railroad's investment decisions, which are driven solely by the railroad's private return on investment. Public benefits do not factor into the railroad industry's investment decisions.

ES4 IMPACT OF CAPACITY CONSTRAINTS ON COMPETITION

Stakeholder Feedback on Causes of Capacity Constraints

As we report in Chapter 5, a generally held opinion among the stakeholders who provided input to us is that the rail industry has gone from excess capacity to "tighter" capacity in the last few years. Other widely held opinions are that rail capacity investment is lagging demand growth (aside from cyclical or seasonal factors), and that railroads are using rate increases to ration scarce capacity and prioritize traffic on their networks. However, opinions differ regarding why capacity has tightened and the effects of this tightening.

- Some stakeholders are of the opinion that the lag in capacity growth is intentional and used by the railroads so they can raise rates—i.e., it is another aspect of the railroads' exercise of market power. In this regard, some are of the opinion that railroads have been "sitting on their hands" regarding capacity investment until the last few years.
- A contrasting opinion is that lags in capacity additions are not the result of the exercise of market power, but these lags are viewed as normal for an industry when faced with making investment decisions of such magnitude. Individuals expressing this view observed that the industry has recently made a significant

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[40] See Chapter 16.

[41] John G. Larkin and Daniel S. Taylor, *Railroads: Striving to Drive Improved Return on Invested Capital,* Legg Mason Wood Walker, Inc., Summer 2004, p. 24.

transition to tighter capacity after years of excess capacity where cost cutting and capacity reductions were the primary focus.

- Also adding to the investment lag, in some cases, is the involvement with the public sector—e.g., obtaining permits and/or funding.

Assessment of the Impact of Capacity Constraints

As noted in Chapter 3, network industries, including the railroad industry, often are capital-intensive and need to make capital investments in large increments. Furthermore, once these investments are made the capital is either costly to remove or its resale value is small. For these reasons, the amount of capital utilization at any one time will not necessarily be at its optimal level, resulting in either an excess or shortage of capacity.

In Chapter 16 we conclude that congestion at various points or corridors in railroad networks appears to be the major culprit in capacity-related performance issues over the last ten years, and not system-wide lack of capacity. This phenomenon is common in network industries as, for example, in communications networks congestion at network nodes constrains throughput despite almost limitless fiber optic capacity throughout the network. Also, as discussed below, in our stakeholder interviews it was expressed that tight capacity is often related to location-specific constraints in rail networks or in the wider transportation network that are beyond the control of railroads (e.g., ports, highways). Furthermore, our econometric evidence indicates that the price of capital is currently greater than capital's value of marginal product, which implies that the railroad industry is not withholding cost-effective investment.

A concern expressed by several of the shippers we interviewed, and also raised in the GAO report,[42] was that recent capacity constraints may have allowed or caused an increase in the market power of the railroads. Our analysis of the markup of rates over marginal costs, as reflected in the Lerner Index, shows no major changes in the overall Lerner Index over the past few years. At the commodity-specific level, we do observe moderate increases in the Lerner Index for corn, wheat, and metallic ores. However, over the 2000-2006 analysis period the Lerner Index for farm products overall remained constant and declined for several other commodities. Thus, we conclude that recent capacity constraints did not increase the overall exercise of market power by railroads, but coincided with some redistribution of relative markups across commodities.

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[42] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006, p. 3.

ES5 SERVICE QUALITY ISSUES

Stakeholder Feedback on Service Quality

As we report in Chapter 5, a number of shippers we interviewed expressed the theme that service quality has deteriorated as rates have increased. (A caveat to this perception is that service has improved somewhat over the last few years when compared to 2004-2005). Many shippers stated that service variability is the most important issue and causes them the most problems. Much of the problem with service variability was attributed by these shippers to reductions in rail competition. Moreover, many shippers stated that new contracts rarely include auy performance standards or penalties for not meeting standards, so there is an increasing lack of railroad accountability.

Part of the service quality issue was seen as an outcome of deteriorating communications between railroads and shippers. This communication problem appears to have several dimensions:

- Many shippers said that railroads were increasingly adopting a "take it or leave it" attitude.
- The greater use of internet-based communications versus direct access to railroad personnel.
- Inability of railroad bureaucracies to respond to changing conditions.

Two aspects of service quality brought up in our stakeholder interviews were additional costs placed on shippers because of service quality problems, and sources of service quality problems. The additional cost factors, which shippers claimed they incur as a result of railroad service quality problems, include:

- The need to hold additional inventories because of uncertain/variable deliveries. In this regard, some shippers said that consistency of service is more important than speed.
- The need to have larger fleets of railcars to ensure adequate deliveries.
- The need to dedicate shipper personnel to the monitoring of railroad performance.
- Congestion in ports caused by additional lead time used as a hedge against service variance.

Regarding the sources of service quality problems, the following were mentioned as possible causes or contributing factors:

- Tight capacity and the "fragility" of the railroad network. Shippers expressed the opinion that with the railroad network operating at close to its capacity, it does not take much to upset the fluidity of the railroad network.
- Tight capacity is often related to location-specific constraints or "choke points" in rail networks.
- Rail service problems can also be related to congestion points in the wider transportation network—ports, terminals, highways—that are beyond the railroads' control.
- Shipper-caused problems—e.g., slow unloading.
- Railroad management structures that impede the ability to improve service or solve problems despite good intentions. In this regard, we heard that railroads are good at serving "cookie cutter" business but have trouble when conditions deviate from the norm. We also heard that because railroads tend to be very large and dispersed businesses, it can be difficult for a railroad to ensure that decisions made at one level/location are actually carried out at lower levels or distant locations.
- Market-dominant firms can be less concerned with providing good service.
- One shipper stated that one reason rail service has deteriorated is because railroads are forcing routing protocols on shippers under the guise of operating efficiency, but these forced routes offer no better (or even worse) transit times than previously allowed routes.

Train Speed as an Indicator of Service Quality

As discussed in Chapter 17, average train speed is a proxy for service quality, and changes in average speed represent changes in performance and service quality. The Railroad Performance Measures (RPM) data allow us to calculate average train speeds across a railroad's network but do not allow for route-specific or corridor-specific analysis, nor do the RPM data allow an evaluation of on-time performance or variability of performance from a shipper's perspective.[43] The average train speeds calculated from RPM data provide a crude, aggregate proxy for the railroad service performance received by shippers. Our Advisory Panel noted that railroads as well as many shippers record and keep data on service metrics such as cycle times. While such information is likely confidential, it was suggested that the STB may need to require the reporting of this type of data—possibly by route or by commodity—to better identify and rectify service quality issues.[44]

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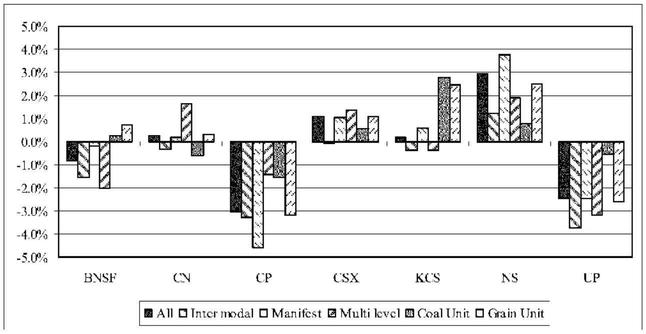
[43] Association of American Railroads, at http://www.railroadpm.org/Definitions.aspx:

> Train Speed measures the line-haul movement between terminals. The average speed is calculated by dividing train-miles by total hours operated, excluding yard and local trains, passenger trains, maintenance of way trains, and terminal time.

Comparisons of changes in average speed across train types provide an indication of changes in service quality across customers of these train types.[45] Figure ES-14 present changes in average speed by train type between January 1999 and September 2005 for each of the Class I railroads.[46] Changes in service quality across shipper classes would be suggested if particular train types have changes in average speeds that are markedly different than the changes in average speeds of other train types. For example, in our stakeholder interviews, the opinion was expressed that high-margin services such as intermodal receive preferential service to the determinant of other commodity groups. Therefore, although it is admittedly at a very aggregate level, if we observe the average speed for intermodal increasing relative to the average speed of other train types, this would be evidence supporting the opinion voiced by theses stakeholders.

FIGURE ES-14
CHANGES IN AVERAGE SPEED BY RAILROAD AND TRAIN TYPE, 1999-2005



From Figure ES-14, there does not appear to be any strong bias toward intermodal, as its average speed declined for all railroads except

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[44] The STB's Rail Energy Transportation Advisory Committee has formed a Performance Measure Subcommittee to investigate performance reporting.

[45] Comparisons across railroads are not necessarily meaningful.

[46] As we discuss in Chapters 16 and 17, definitional changes in RPM data implemented in October 2005 make comparisons of data before and after these changes problematic. Therefore, our analysis of RPM data is conducted for two separate periods.

NS over the 1999-2005 period, and its speed worsened relative to the overall average for all the railroads.[47] In fact, the change in intermodal's speed was below the change in average speed of coal units and manifest for most railroads over this time period. Therefore, there does not appear to be any systematic bias in favor of intermodal shipments over this time period.

Variability in Average Speed by Train Type

Not only do average speeds have implications for service quality, but variability in speed is also important. In fact, one of the major complaints we heard from shippers regarding service quality was that variability in railroad performance was a larger problem than the absolute level of performance. Shippers found unpredictable service performance to be more costly and problematic to deal with than service that resulted in longer but predictable delivery performance.

The variability in average train speed by railroad and train type (and, presumably, the resulting variability in delivery performance to shippers) is measured by the coefficient of variation (CV), which is the ratio of the standard deviation of train speed to average train speed. Table ES-7 presents CVs of train speed by railroad and train type stated as a percent of average speed.[48] For each railroad, examining CVs across train types reveals that the lowest CV in most cases is for intermodal, especially during the 1999 to September 2005 period. Grain units and coal units typically have the highest CVs. Thus, the implication is that even though its average speed generally declined over this period, intermodal typically received the most predictable service. On the other hand, coal units and grain units received the least predictable service.

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[47] This may be due, in part, to major construction projects noted elsewhere in this study.

[48] Again, comparisons across railroads are not necessarily meaningful.

Table ES-7
Variability in Average Train Speed by Railroad and Train Type

Measured by the Coefficients of Variation

	Inter modal	Manifest	Multi level	Coal Unit	Grain Unit
1999-Sept. 2005					
BNSF	3.6%	3.6%	4.2%	4.9%	4.6%
CN	3.9%	5.1%	6.1%	8.0%	9.4%
CP	5.1%	5.6%	6.8%	5.9%	7.3%
CSX	3.5%	5.1%	6.3%	4.4%	6.3%
KCS	5.5%	7.0%	5.6%	8.2%	8.9%
NS	3.2%	4.4%	5.4%	4.5%	7.1%
UP	3.6%	3.5%	3.9%	4.9%	5.1%
2006-2007					
BNSF	3.8%	4.3%	3.9%	4.4%	4.4%
CN	3.5%	3.5%	5.3%	5.9%	4.5%
CP	4.0%	3.6%	5.9%	8.9%	5.2%
CSX	3.4%	3.8%	4.5%	3.4%	4.3%
KCS	6.0%	4.6%	6.0%	6.5%	5.2%
NS	3.6%	4.1%	5.1%	3.6%	5.7%
UP	3.6%	3.1%	3.2%	4.2%	3.7%

ES6 Implications for Proposed Policy Changes

The economic context in which we assessed the various recent proposals for policy changes in the railroad industry is that the exercise of market power appears to have increased in the freight railroad industry over the last twenty years, but has been necessary in order to obtain revenue sufficiency. Only in the most recent year of our analysis does industry revenue noticeably exceed industry cost by our R-1 based measure. Furthermore, the recent increases in revenue per ton-mile appear to be largely the result of increases in variable, fixed, and marginal costs—related to increases in the railroad industry's input prices and diminishing productivity growth—and not due to the increased exercise of market power. While recognizing that differential pricing and the exercise of local market power is necessary to achieve financial viability, in both our qualitative and quantitative research, we did find concerns about shipper captivity and railroad performance.

The 2006 GAO report discussed four open access proposals (three of which have been included in recently proposed legislation) to address competitive concerns: reciprocal switching agreements, requiring the quotation of bottleneck rates, terminal agreements, and trackage rights agreements. We examined these proposals in Chapter 22. Table ES-8 recreates our summary of the likely economic effects of these open-access proposals. The assumption made for each of these proposals is that, although these types of open-access arrangements would be mandated to some degree, the terms of access are allowed to be determined through voluntary negotiations between railroads, with STB oversight of the process. To the extent that the terms of access are set according to some legislative or regulatory formula that differs from the outcome of voluntary negotiations, the economic effects of these open-access proposals become less predictable.

TABLE ES-8
LIKELY ECONOMIC EFFECTS OF VARIOUS OPEN-ASSESS PROPOSALS

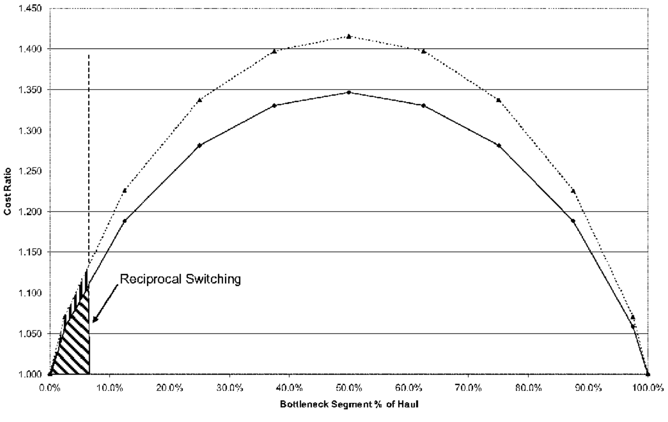
	Reciprocal Switching	Bottleneck Rates	Terminal Agreements	Trackage Rights
Economics of Density	Potential gains	Gains unlikely	Potential gains	Potential gains
Length-of-Haul Economics	Small loss	Potentially large loss	No gain to small gain	No gain to small gain
Vertical Economies	Small loss	Potentially large loss	Small loss	Potentially large loss
Investment Incentives	Small effect	Potentially large effect	Small effect	Potentially large effect
Railroad Profitability	Small effect	Potentially large effect	Small effect	Potentially large effect
Coordination Costs	Small to moderate	Small to moderate	Small to moderate	Potentially large
Competitive Response	Most likely	Least likely	Most likely	Somewhat likely
Shipper Gains	Most likely	Least likely	Most likely	Somewhat likely

Our assessment that, overall, the railroad industry is pricing at levels generating earnings that maintain or slightly exceed those necessary to ensure financial viability implies that there is little room to provide significant "rate relief" to certain groups of shippers without requiring increases in rates for other shippers or threatening the railroads' financial viability. Thus, distributional effects among shipper groups, as well as between shippers and railroads, are primary considerations of proposed policy changes. While economic analysis may be able to quantify benefits and costs to specific stakeholders given more precise policy proposals, the cost/benefit balance is ultimately to be struck by policymakers.

Given the current structure and performance of the railroad industry, we find that certain "open-access" proposals, such as reciprocal switching and terminal agreements, are more likely to create favorable economic benefit/cost conditions than more sweeping access reforms. Some policy initiatives such as requirements to offer bottleneck rates or trackage rights over any route segment, may not be workable due to coordination issues, or may not be effective because the economics of the proposed policy change (e.g., loss of length-of-haul economies, and/or vertical economies) are unlikely to produce the anticipated degree of competitive response.

For example, Figure ES-15 illustrates the stylized fact that length-of-haul economies are diminished as interchange between two railroads (assumed for the purpose of this illustration to be equally efficient) occurs further from an endpoint of a movement; the adverse effect on costs is maximized when the interchange occurs at the mid-point of the end-to-end movement. The magnitudes of the effects shown in Figure ES-15 are consistent with the length-of-haul effects on revenue per ton-mile estimated in our pricing models and, by implication, the length-of-haul effects on marginal costs. As we discuss in Chapter 22, reciprocal switching agreements, which occur a limited distance from an endpoint—indicated by the shaded areas in Figure ES-15—will result in higher costs per ton-mile on the short "bottleneck" segment relative to an end-to-end movement, but there will be relatively little loss of efficiency for the longer-haul segment. Thus, because they have lower risks of adverse cost consequences, we believe that "incremental" policies such as reciprocal switching and terminal agreements have a greater likelihood of resolving shipper concerns via competitive response, without leading to material adverse changes to railroad costs and efficiency.

FIGURE ES-15
STYLIZED REPRESENTATION OF RAILROAD INTERCHANGE AND LENGTH-OF-HAUL ECONOMIES



Nevertheless, we can identify certain proposals we believe would result in economic harm for both shippers and railroads, such as the implementation of cost standards in the STB's rate review process that are based on economically discredited methodologies, and a strictly quantitative assessment of market dominance based solely on the R/VC ratio. Regarding the assessment of market dominance using R/VC alone, the weak relationships between R/VC ratios and market structure factors imply that correctly assessing the presence of market-dominant behavior requires direct assessment of relevant market structure factors as in the current regulatory scheme. Thus, regulatory changes that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance would not be appropriate.

We also recognize that policies to introduce greater competition in the railroad industry will not necessarily benefit all shippers. Some shippers are truly captive because of factors such as geographic location and/or low shipper density. Therefore, effective regulatory oversight will still be important regardless of any efforts to induce greater competitive responses in the railroad industry. Improvements in the STB's oversight and processes, such as the recent efforts to improve its simplified methods, are important. Also, as discussed in Chapter 22, to the extent the threat or possibility of final offer arbitration promotes parties to negotiate and reach voluntary agreements or resolve disputes, as suggested by a number of stakeholders we interviewed, it would improve the functioning of private markets without imposing additional regulatory burdens. However, if matters are not resolved between parties and matters do go to arbitration, there are real concerns whether the process will produce outcomes consistent with competitive market outcomes, particularly if arbitrators are not experienced in the complexities of railroad economics. Additionally, factors such as improved reporting of service quality data in industry service metrics and shipment-level CWS data can lead to a better understanding of railroad performance and shipper behavior.

In order to succeed, any of the policy reform proposals must address important implementation details. Based on the experiences of the railroad industry and other industries with legislated access policies, the most challenging and time-consuming aspects of implementing policy changes is working out the details of access terms and pricing, and doing so in a way that enhances, not diminishes, economic efficiency. Not only can the terms of access have an effect on the degree to which open access occurs, but it can have important effects on incumbents' investment behaviors. None of the current policy proposals address these details and, therefore, the risks entailed in implementing these policies as written carry the very real possibility of unintended and economically harmful outcomes.

ES7 CONCLUSIONS AND FUTURE RESEARCH DIRECTIONS

This report presents the findings of an independent study of the competitive state of the U.S. freight railroad industry performed by the study team assembled by Christensen Associates and commissioned by the U.S. Surface Transportation Board (STB). Over the course of this 14-month study, the Christensen Associates study team has received cooperation from the STB and numerous railroad industry stakeholders including railroads, various shipper group organizations, numerous individual shippers, government organizations, academics, and other stakeholders. While valuable insights and assistance were obtained by the study team through this process, no individual, government agency, railroad, shipper, or any other industry stakeholder has exerted any influence on the findings of this study. The findings presented and conclusions reached in this report represent the professional judgments and opinions of the Christensen Associates railroad study team.

In addition to the research the Christensen Associates study team performed in the course of our year-long study and our conclusions from that research, we believe there are a number of areas where future research efforts would improve the understanding of the U.S. freight railroad industry. A number of these potential research issues came up during the course of our stakeholder interview process but were outside the scope of the current study. In the case of some issues, the current lack of adequate data prevents a thorough empirical examination. We see other areas as a natural extension of the research we have performed for this study. The topical list below is in no particular order of importance, nor is it meant to be an exhaustive list of pertinent topics in the railroad industry that merit further investigation.

Captivity and Effective Competition

The weak relationships we found between R/VC ratios and market structure factors imply that correctly assessing the presence of market-dominant behavior requires direct assessment of relevant market structure factors. A better empirical understanding of the economic dimensions of rail shipper captivity is critical, particularly in light of proposed regulatory reforms that would establish R/VC tests as the sole quantitative indicator of a railroad's market dominance.

Service Quality

To evaluate many of the shippers' service quality concerns at more than aggregate or anecdotal levels, data that capture service performance metrics at a disaggregate level are necessary. As we noted, one member of our Advisor Panel indicated to us that railroads as well as many shippers record and keep data on service metrics such as cycle times. While such information is likely confidential, it was suggested that the STB may need to require the reporting of this type of data—possibly by route or by commodity—to better identify and rectify service quality issues. As one step in this direction, perhaps the reporting of complaint statistics on the STB website could be expanded (without breaching confidentiality).

Capacity

Another area that would benefit from a more disaggregate analysis is railroad capacity, particularly given our conclusion that capacity "tightness" issues have most likely been due to localized congestion and constraints, and not because of a system-wide lack of capacity. Also, more disaggregated RPM-type data on railroad performance would be helpful to better investigate capacity issues as well as service quality concerns. Another aspect of railroad capacity that was brought up in our stakeholder interview process is whether railroad equipment markets operate efficiently, supplying the appropriate amount of equipment.

Cost Shifting

A number of stakeholders indicated to us that there has been a significant amount of "cost shifting" in recent years, whereby costs or investments that were previously undertaken by railroads are now the burden of shippers. Examples of cost shifting to shippers include increases in investments in track and storage facilities, loading and unloading facilities, car ownership and maintenance, and accessorial charges. We have been able to examine some of these issues—for example, the increase in third-party car ownership and our empirical results that indicate rates are generally lower across a number of commodity groups when shipper-owned cars are used. However, many of the cost-shifting issues appear to require additional data to enable a thorough empirical investigation. To the extent such issues are critical to shippers, the STB may consider requesting that appropriate data be made available to investigate these cost-shifting concerns.

Fuel Surcharges

Although the STB has recently begun to collect data on fuel surcharges, these data have not been collected long enough at this point in time to perform a reasonable analysis. For example, the effectiveness of the new STB rules on fuel surcharges has yet to be fully evaluated.

Issues Related to Class II and Class III Railroads

As discussed in Chapter 5, some smaller railroads expressed a number of concerns, including the relationship between smaller and Class I railroads with respect to Class I's "cherry-picking" traffic, and Class I's offering non-competitive rates. In addition, because many smaller railroads have had to undertake significantly greater investments (proportionately speaking) than Class I railroads, the question is whether shortline networks are underfunded.

Critical Evaluation of Rail Demand Growth Projections

There are a number of studies that project a widening gap between the demand for rail services and railroad capacity. These demand projections provide a basis for projecting investment needs and support for the importance of continued railroad earnings growth. Because of the important implications of these demand projections, there needs to be a critical evaluation of these projections and future rail capacity needs.

Reduction in Railroad Network Access

A concern expressed to us by a number of agricultural shippers was the reduction in railroad network access points. As discussed in Chapter 5, potential research questions here include the extent of reduced access, whether it has resulted in railroad efficiency gains and overall benefits to shippers, and whether it has shifted costs to other modes of transportation (such as increased highway maintenance costs).

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Consumer Federation of America

BULK COMMODITIES AND THE RAILS:
STILL CRAZY AFTER ALL THESE YEARS

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MAY 2009

CONTENTS

EXECUTIVE SUMMARY 1

PART I: INTRODUCTION AND OVERVIEW 5

I. OVERVIEW AND SUMMARY 6
- Why Consumers Care about Railroad Monopoly Power 7
- Finding 10
- The STB Competition Analysis 11
- Policy Recommendations 13
- Outline 16

II. ANALYTIC FRAMEWORK 17
- Definitions and Concepts 17
- Efficiency 19
- Analyzing Market Structure: Measuring Market Concentration 23
- Regulation Where Market Power is Endemic 29

PART II: STRUCTURE AND CONDUCT: RAILROAD MARKET POWER 31

III. MARKET STRUCTURE, CONDUCT AND BASIC CONDITIONS IN THE RAIL INDUSTRY SINCE THE PASSAGE OF THE STAGGERS ACT 32
- Merger Create a Highly Concentrated, Tight Oligopoly 32
- Mergers, Productivity and Market Power 36
- Stifling Competition Through Foreclosure 37

IV. MARKET CONDITIONS AND MARKET POWER 41
- Inadequate Capacity 41
- Energy Prices 44
- The Decline of Competitive Rivalry 46

PART III: THE ABUSE OF MARKET POWER IN THE RAIL INDUSTRY 49

V. PERFORMANCE: NATIONAL PRICE INCREASES 50
- National Rate Increases 50
- Surcharges 53

VI. PRICE INCREASES IN LOCAL MARKETS FOR SPECIFIC COMMENTS 56
- Geographic and Product Markets 56
- The Importance of Competition 61
- Service Quality 62

VII. PROFITS, EXCESS PROFITS AND CROSS-SUBSIDIES 66
Profitability 66
Revenue-to-Variable Cost 69
VIII. Conclusion 72

LIST OF FIGURES

II-1: The Structure Conduct Performance Model of Industrial Organization 13
II-2: Criteria of Workable Competition 20
II-3: Describing Market Structures 26
III-1: Rail Mergers Since the Passage of the Staggers Act 33
III-2: The Increase of Concentration Since the Staggers Act Measured by the HHI 34
III-3: The Increase of Concentration Since the Staggers Act Measured by the Four Firm Concentration Ratio 34
III-4: Number of Class I Railroads Service Economic Areas 35
IV-1: Rail Demand Exceeds Supply 43
IV-2: Truck v. Rail rates 44
IV-3: Rising Energy Prices Trigger Rent Seeks by Railroads 46
V-1: Revenue of the Four Major Freight Railroads (BNSF, CSX, NS, UP) 50
V- 2: Pricing Power and Revenue Growth 52
V-3: Miscellaneous Revenues 53
V-4: The Growing Importance of Fuel Surcharges as a Rail Profit Center 54
V-5: Fuel Surcharges Become a Profit Center 55
VI-1: Cost of Captivity 2003:2007: Ratio of Captive Rate to Non-competitive Rates 57
VI-2: RVC Ratios for Pacific Northwest Wheat Shipments 58
VI-3: RVC Wheat Shipments Nebraska – Pacific Northwest 58
VI-4: Upper Midwest Grain Shipments 59
VI-5: Post Merger Rate Increases on Individual Routes 60
VI-6: Entry of Competitive Rail 61
VI-7: Water-Rail Competition 62
VI-8: Past Due Grain Orders 64
VII-1: Net Income and Return on Investment 67
VII-2: Earnings Per Share 67
VII-3: Rail Industry Cost of Capital and Return on Investment 68
VII-4: Return on Net Investment 2007-2008 69
VII-5: 2005 Revenue and Variable Costs 70
VII-6: Revenue to Variable Cost Ratios 71

EXECUTIVE SUMMARY

This report examines the freight rail industry's impact on the price of goods and services by analyzing the structure, conduct and performance of the freight rail industry since the passage of the Staggers Rail Act of 1980, which deregulated the railroads and sparked an era of mergers and acquisitions. The Consumer Federation of America, publisher of the report, is a non-profit association of over 300 consumer organizations with a combined membership of over 50 million Americans that has been involved in public policy affecting the rail sector for almost thirty years. CFA has taken up this issue because consumers shoulder the burden of excessive rail rates in the price of goods and services they consume, particularly electricity. Two thirds of the coal shipped by rail is captive to a single railroad and excessive coal rates are passed through directly into the electricity bills consumers pay every month. Moreover, excessive rail rates paid by captive shippers in other sectors, like agriculture and chemicals, also distort the economy, lowering output and employment.

This market power has proven profitable for the railroads, as demonstrated by their strong performance on Wall Street in recent years. Unfortunately, shippers that seek rate relief through regulatory channels have found that the STB uses a flawed approach to evaluate railroad profits, making it virtually impossible for rail customers to receive meaningful rate relief. This report addresses the failure of regulators to implement the captive shipper protections in the Staggers Act, and the regulators' overprotection of the railroads at the expense of captive shippers.

THE CURRENT ABUSE OF MARKET POWER IN THE RAIL INDUSTRY

Our analysis shows that excessive consolidation in the freight rail industry and lax oversight of anticompetitive business practices has given the railroads an immense amount of market power. With only a handful of companies providing freight rail service, many rail customers have access to just one railroad and are, therefore, "captive" to that railroad. This enables the railroads to set prices well above costs, essentially extracting monopoly rents from shippers, and creates little incentive for railroads to provide consistent and reliable service.

- Captive shippers pay a premium of 75 to 100 percent compared to similar movements in competitive markets, and the cost of captivity has been rising substantially in the past five years.
- In fact, handling captive shippers rail traffic represent less than one-fifth of total costs to railroads but provides two-thirds of their profits.
- Excessive fuel surcharges and other add-ons have also skyrocketed in recent years, and have become a major component of the rising cost of rail service. Studies have shown that more than half of recent railroad fuel surcharges were unwarranted and charged at the expense of shippers and ultimately consumers.

- Although the Surface Transportation Board (STB), which oversees the rail sector, sets the standard for a fair return on investment by railroads far above what Wall Street deems necessary, several railroads exceed that level, resulting in excess profits of over a billion dollars.
- Over one quarter of all rail traffic is shipped at rates that are below costs. Captive shippers pay higher rates to subsidize this below-cost traffic. This practice burdens captive shippers and creates a cross-subsidy of over $2 billion per year.

Abuse of market power sustains $3 billion per year of excess profits and costs srocc-subsidies, cost that fall on the shoulders of captive shippers.

ABANDONING COMPETITION

The STB and its predecessor agency, the Interstate Commerce Commission (ICC), allowed a merger wave to engulf the industry, reducing it from a state of vigorous competition, to a state of near monopoly. While some consolidation in the rail industry was certainly necessary, by the mid-1990s, the benefits of consolidation had been captured. Over the opposition of the Department of Justice, the STB allowed mega-mergers to take place in the mid-1990s that rendered much of the nation captive to, at best, duopolies in the east and west. Vast swaths of America's heavy industries, raw materials and agricultural heartland are now captive to one or two railroads.

The ICC/STB failed to implement the most fundamental principles of antitrust in connection with essential or bottleneck facilities. Captive shippers, who are within a few miles of a competitive alternative, are denied access to competition by the refusal of the railroads to allow movement of traffic across short monopoly stretches of road.

To add insult to injury, the STB has allowed the railroads to erect paper barriers to competition. As the mega-mergers were taking place, the dominant freight roads, desiring to specialize in the long haul transport of bulk commodities, found it convenient to spin-off short lines to service individual facilities or local areas. However, in order to ensure that the long haul freight railroads would be able to exploit their newly minted market power, the dominant railroads forced the new short lines to sign contracts that said in essence, "thou shalt not compete or do anything that promotes competition."

THE FAILURE TO PROTECT CAPTIVE SHIPPERS FROM COMPETITIVE ABUSE

Having allowed the railroads to consolidate so dramatically, captive shippers implored the STB to exercise its regulatory authority to prevent the abuse of market power, but the STB turned a deaf ear.

First, the STB clings to a rate threshold that allows the railroads to charge up to what it would cost for the shipper to build a stand-alone railroad, exactly what the monopolist would charge. No other regulatory agency in American history has ever adopted this standard. To make matters worse, the burden is on the shipper to calculate the standalone cost in a proceeding that can take years and cost millions of dollars.

Second, the STB has taken an approach to the calculation of the rate of return necessary for revenue adequacy that vastly overstates the railroads' need for revenue. The STB's weighted average cost of capital is one-fifth higher than the cost of capital calculated by Wall Street analysts. This allows railroads to increase charges on their captives in pursuit of an absurdly high revenue target.

Third, the STB has failed to require that the railroads operate their business in an efficient manner. More than a quarter of a century after the passage of the Staggers Act, one fifth of all rail traffic does not cover its variable cost. If the railroads shed this traffic, their costs would go down by $2 billion. If they raised their rates to compensatory levels, their revenues would go up by $2 billion. In either case, the railroads would be shown to be more than revenue adequate and, in theory, captive shipper rates would come down.

POLICY RECOMMENDATIONS

The extent of monopoly power abuse identified in our study highlights the need for urgent action to protect freight rail customers and consumers. Legislation is necessary because the regulators have failed to properly implement the provisions of the Staggers Act for a quarter of a century. The regulatory oversight over rail market power should be strengthened.

Removing Barriers to Competition

First, since competition is the best form of consumer protection, we begin by describing the policy changes necessary to reinvigorate rail-to-tail competition. After a quarter of a century in which competition has shriveled in the industry, the exemption from the antitrust laws that Congress granted to the railroads in the Staggers Act should be eliminated. Lifting the exemption from the antitrust laws will immediately expose the most blatantly anticompetitive practices, like paper barriers, to pressures for their elimination. The permanent structural barriers to competition posed by terminal and bottleneck facilities will also come under pressure.

Preventing the Abuse of Endemic Market Power

Second, policy makers should be under no illusions that antitrust can eliminate the pervasive market power in the consolidated rail industry. The highly concentrated market structure and substantial physical barrier to entry mean that even where the artificial, conduct-based impediments to competition are removed, there will be a great deal of market power remaining in the sector. Thus, regulatory oversight to effectively protect captive shippers from abuse will still be necessary.

No other regulatory agency uses the "stand-alone cost" (SAC) test, which allows the railroads to charge what an unregulated monopolist would charge. The SAC test was adopted in 1985 to permit railroads to charge the highest rates economists could justify, due to the rails' then-revenue inadequacy and then-excess capacity. Those justifications no longer apply, so there is no justification for the SAC test, if there ever was. It should be repealed. The STB should return to a rate standard based on cost plus a reasonable return. The railroads should bear the burden of proving that rates above the threshold of 180 percent of variable cost are reasonable, including a showing that all traffic is compensatory.

The STB has consistently overstated the cost of capital, allowing the rails to abuse their market power and earn excess profits. The STB must use the cost of capital used by other regulatory agencies and Wall Street.

PART I:

INTRODUCTION AND OVERVIEW

I. PURPOSE, OUTLINE AND SUMMARY

This paper presents an analysis of the nature and extent of the abuse of market power by American railroads and its impact on consumers. Where there is a lack of competition, i.e. where shippers are captive to a railroad, the railroad can set prices far above costs, extracting monopoly rents from shippers and ultimately consumers, or delivering poor service, which imposes costs on shippers, consumers and the nation.

The problem facing consumers is particularly acute in the electricity sector. About half of all electricity generated in the U.S. is produced from coal and electricity is sold to consumers by franchise monopolies or with little competition.[1] Almost 70 percent of coal used in the U.S. is transported by rail and it is a commodity over which the rails have a great deal of market power.[2] Two-thirds of coal deliveries are to facilities that are served by only one railroad.[3] Thus, excessive rail rates appear directly in consumer utility bills. For individual utilities dependent on monopoly rail service, the excess charges can cost consumers as much as $100 per year per household.[4]

Because of these consumer impacts, consumer advocates have a long history of involvement in efforts to secure better oversight over abusive practices in the rail sector. In a series of congressional testimonies[5] and reports[6] the Consumer Federation of America called on congress to require rail regulators to protect consumers from the abuse of market power. As the Staggers Rail Act of 1980 was being considered by Congress, consumer groups expressed their concern that they would directly bear a significant part of the burden caused by the abuse of market power as consumers when prices are increased to reflect excessive rails rates. Even where costs increases are not passed through directly to consumers, the public should be concerned because excessive rail rates distort economic activity, reducing the efficiency of the economy, shifting jobs, and increasing the number of heavy trucks on the roads, which causes congestion and wear-and-tear on infrastructure.[7]

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[1] Generation figures are available at http://www.eia.doe.gov/cneaf/electricity/epm/table1_1.html; Restructured states can be found at http://www.eia.doe.gov/cneaf/electricity/page/restructuring/restructure_elect.html. Consumption in individual states can be found at http://www.eia.doe.gov/fuelelectric.html. Sales in non-restructred states represent over two-thirds of total sales and there is considerable doubt about the extent of competition in many of the restructured states.

[2] Data available at; http://www.eia.doe.gov/cneaf/coal/ctrdb/tab31.html

[3] Surface Transportation Board, *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition,* pp. 18-15 n. 13, 18-14 n. 15.

[4] "Testimony of Terry Huval, Director Lafayette Utility Systems, *House Judiciary Committee Hearing on Railroad Antitrust Enforcement Act* February 25, 2008.

[5] "The Staggers Rail Act of 1980," before the Subcommittee on Commerce, Transportation and Tourism of the Committee on Energy and Commerce, United States House of Representatives, July 27, 1983; "Oversight Hearings on the Staggers Rail Act of 1980," before the Subcommittee on Surface Transportation of the Committee on Commerce, Science and Transponation, United States Senate, July 26-27, 1983; "The Consumer Impact of the Proposed Norfolk Southern/Conrail Merger," before the Subcommittee on Commerce, Transportation and Tourism of the Energy and Commerce Committee. U.S. House of Representatives, July 10, 1985; "The Consumer Impact of the Unregulated Railroad Monopoly in Coal Transportation," before the Subcommittee on Monopolies and Commercial Law of the Judiciary Committee, U.S. House of Representatives, June 27, 1985; "Railroad Antimonopoly Act of 1986," before the Subcommittee on Commerce, Transportation and Tourism of the Energy and Commerce Committee, U.S. House of Representatives, June 5, 1986

[6] Cooper, Mark, 1985b, *Industrial Organization and Market Performance in the Transportation and Communications Industries,* July 1985; *The Great Train Robbery: Electric Utility Consumers and the Unregulated Rail Monopoly Over Coal Transportation, Overview, The Rail Monopoly Over Bulk Commodities, A Continuing Dilemma for Public Policy,* August 1985c;Maark Cooper, 1987, *Bulk Commodities and the Railroads After the Staggers Act: Freight Rates, Operating Costs and Market Power,* October 1987.

The level of consumer involvement has reflected the level of abuse in the industry. As described in the next chapter abuse was high in the years immediately following the passage of the Staggers Act, moderated for a decade, but was reignited by a wave of mega-mergers in the 1990s. Recent developments in the industry, including a shortage of capacity and rising energy prices have opened the door to a dramatic uptick in the abuse of market power.[8] In reaction, consumers and shippers have increased their efforts to convince policy makers to restore the consumer protections that Congress intended be provided by the Staggers Act. This paper makes the case that the abuse of market power has increased in recent years and that the need for reforms to rein in this abuse has become urgent.

WHY CONSUMERS CARE ABOUT RAILROAD MONOPOLY POWER

The underlying cause of the current problems is the poor design and lax implementation of railroad deregulation under the Staggers Rail Act of 1980. There is no doubt that the railroads were in bad shape in the 1960s and 1970s and in desperate need of economic rationalization. In the decade after the Staggers Act was signed into law, railroads made great strides in reducing costs, abandoning or shifting track to small rails, and restoring their financial health.[9] Unfortunately, as frequently happened in the deregulation process of the 1980s and 1990s, the legislation went too far and the regulators did not provide effective oversight. Excesses soon set in that regulators failed to prevent.

The Staggers Act created a large group of captive shippers, shippers who lacked competitive alternatives (either rail-on-rail (intramodal) or truck/barge-on-rail (intermodal) competition). Since these shippers would not be protected from abuse by competitive market forces, the Staggers Act included captive shipper protections. The protections were weak and the regulators who implemented them, first the Interstate Commerce Commission (ICC) and its later replacement the Surface Transportation Board (STB), failed to effectively protect captive shippers from abuse. These agencies not only failed to restrain rate increases on captive traffic, but they made matters worse by approving a string of mergers that dramatically reduced competition in the industry.[10] To add insult to injury, the regulators failed to prevent anticompetitive pricing, routing, and contracting practices that shut the door on competition. Two decades after the passage of the Staggers Act, four railroads (two in the east and two in the west) accounted for over 90 percent of rail traffic and much of that traffic is vulnerable to the abuse of market power because the industry was allowed to become too concentrated.

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[7] Testimony of George Spitzer, Vice President DuPont Chemical Solutions Enterprise," *House Transportation and Infrastructure Committee, September 25, 2070, pp. 9-10;* "Testimony of Susan M Diehl, Senior Vice President of Logistics and Supply Chain Management, Holcim, *House Transportation and Infrastructure Committee, September 25, 2070, p. 7.*

[8] Morgan Stanley, *Transportation: Initiation of Coverage: Rails Have More Room to Run on Pricing,* May 7, 2007

[9] GAO *Freight Railroads: Industry Health Has Improved, but Concerns About Competition and Capacity Should be Addressed,* October 2006.

[10] The concentration of the national market increased from an HHI of 500 to an HHI of well over 200, indicating a shift from being highly competitive to highly concentrated. Transportation Research Board, *Research to Enhance Rail Network Performance* (Washington, D.C.: 2007), p. 68. The four firm concentration ratio increase from about 40 percent to about 80 percent. Regional and local markets have become even more highly concentrated.

Captive shippers, including those who had competitive alternatives but lost those alternatives as a result of mergers, found themselves worse off under the Staggers Act. They had argued in Congress before passage of the Staggers Act and in regulatory proceedings at the ICC after its enactment that economic efficiency should not be confused with the abuse of market power. They sought additional protections that would rein in the abuse, but to no avail. By the mid-1990s, analysts began to find that abuse of market power was growing and consolidation in the industry was excessive.[11] But the ICC and the STB did little to prevent the resulting abuse.

The commodities most affected by the change in rail industry structure and conduct are bulk commodities (especially coal, chemicals, grain, forestry products). These are heavy, low- value commodities that are transported in large volumes and at long distances. Their economic characteristics generally make transport by truck prohibitively expensive, so effective competition is limited to rail and water. With barge transport restricted to major rivers and bodies of water and trucks far too expensive, bulk shippers are frequently dependent on the rails to move their products. For example, truck and water transport each account for about ten percent of coal produced in the U.S., whereas rail accounts for 71 percent.[12]

Where head-to-head rail competition is lacking, shippers pay the price of captivity. Where the ultimate burden of excessive rail rates falls depends on the nature of the market into which the captive shippers sell their products, but in all cases the abuse of market power has a negative impact. Where markets for end-products are competitive, shippers will bear the burden. Placed at a competitive disadvantage vis-à-vis shippers who have competitive alternatives, the shipper will lose sales, or be forced to shift production to facilities that are not captive, either in the U.S. or abroad. Industrial shippers, particularly chemicals, fall into this category. The shippers and the economy bear the cost of the distortion introduced by the abuse of rail market power.

Where markets for end-products are not competitive, the excessive rail rates will be passed through to consumers. Here the only constraint will be the market elasticity of demand. Coal, which is predominantly used to generate electricity, is the primary example and concern here. Although efforts have been made to introduce competition into electricity markets, the majority of markets are monopoly franchise markets and even where competition has been introduced, it is feeble at best. Thus, electricity consumers are the captives of utilities, who are the captive of the railroads. Electricity also has a low market elasticity of demand. Thus, the costs imposed by excessive rail rates are passed through directly to consumers.

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[11] Chapin, Alison and Stephen Schmidt, "Do Mergers Improve Efficiency? Evidence from Deregulated Rail Freight," *Journal of transportation Economics and Policy,* 33 part 2; argues that the second round of mergers were about market power, not efficiency. Christopher Vellturo, et Al. *Deregulation, Merges and Cost Savings in Class I U.S. Railroads, 1974-1986*, March 23, 1992,p. 1' find that "firms that were not engaged in significant merger activities experienced similar cost differentials due to changes in operating characteristics and labor force utilization… We conclude that although mergers did confer some benefits on the participating fires, they were not a prerequisite for railroads being able to achieve substantial cost savings during the post Staggers period;" Charles H. White, Jr., "The Merger Movement and the Functional Change o the U.S. Railroad Industry,' *The Voyager: The TRANSLOG International News Journal for the 21st Century,* October-Deembe,2004.

[12] Data available at; http://www.eia.doe.gov/cneaf/coal/ctrdb/tab31.html

These are the two extreme conditions and both result in economic distortions. In the competition case, it is the supply side of the shipper market where efficiencies and jobs are lost. In the monopoly case, end-use consumers bear the burden. Some commodities, like agricultural commodities, exhibit a mix of these characteristics. Transportation costs affect the price of food paid by consumers in domestic markets. Farmers bear the burden of excessive rail rates for agricultural commodities that are exported for sale in world markets.

Electricity is a consumer necessity that significantly affects household budgets. Because coal, which is a primary victim of the abuse of rail market power, is the dominant source of power to generate electricity, consumer groups pressed policy makers to address the problem of the unconstrained exercise of market power by the railroads throughout the 1980s.

When the effort to secure legislation to protect consumers stalled, two decades of regulatory skirmishes took place at the ICC/STB, but shippers and consumers have not fared well. The agencies with oversight authority imposed little restraint on rates, allowed mergers to dramatically consolidate the industry, and failed to prohibit anticompetitive practices that undermined competition.

Recently, the effort to protect captive shippers and consumers from the abuse of market power by the railroads has ramped up again, driven by two factors – rising costs imposed on the public and the increasing financial health of the railroads.

In the past half-decade the costs imposed on captive shippers have increased as a result of mergers and consolidation in the rail industry, which increased the market power of the railroads. At the same time, the rise in commodity prices has spurred the rails to try to capture more rent from shippers. Thus, the ability and opportunity to raise shipper costs increased dramatically. As a result, rail profitability has improved dramatically with several railroads achieving or approaching revenue adequacy. Revenue adequacy should trigger greater constraint on rail pricing. Not surprisingly, with revenue adequacy looming the railroads asked the STB to dramatically change the rules of the revenue adequacy proceedings and apply a new replacement-cost methodology that would suddenly show that railroads are not revenue adequate.[13] This would make it more difficult for the STB to impose restraints on rail rate increases. Fortunately, the STB rejected the railroad's petition. Still there is no relief in sight from the relentless abuse of rail market power; railroad rate increases continue unabated.[14] Recently, for example, Seminole Electric Cooperative experienced an increase of 100 percent in its rail rate from CSX and Oklahoma Gas and Electric experienced a large increase from Union Pacific, both of which have been the subject of complaints filed at the STB. US Magnesium and DuPont have also filed rate complaints at the STB, after experiencing substantial rate increases.

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[13] "Petition of the Association of American Railroads to Institute a Rule Making Proceeding to Adopt a Replacement Cost Methodology to Determine Railroad Revenue Adequacy, Ma 1, 2008. Table 1, shows that the new methodology Return on investment by would slash the estimated return on investment.

[14] *Ex Parte* No. 679, served October 24, 2008

The Staggers Rail Act allowed the railroads to engage in differential pricing – to charge some shippers higher rates than others – in order to achieve revenue adequacy. In economic terms, this represents the exercise of market power, which is generally frowned upon in a competitive, capitalist economy. It is necessary in the case of the railroads because the railroads have high fixed costs and exhibit economies of density. Congress knew that captive shippers would bear the burden of differential pricing because competitive market forces are inadequate to protect them, so the Staggers Act set limits on the exercise of market power. The ICC/STB was supposed to ensure that railroads did not earn excess profits and that all traffic made the maximum contribution it could to revenue adequacy. This would ensure that the railroads were run as efficiently as possible and that captive shippers would be treated as fairly as possible. The law allowed the use of market power, but sought to prevent the abuse of market power.

Our analysis shows that regulators have failed in this fundamental task. After more than a quarter of century, neither efficiency nor equity has been achieved.

FINDINGS

We find that excessive consolidation resulting from mergers and lax oversight of anticompetitive business practices have given the railroads an immense amount of market power.

- The dramatic decline in the number of Class I railroads from almost 40 to 7, with two geographic duopolies dividing the country – one in the East and one in the West – has carried consolidation far beyond anything that could have been justified on efficiency grounds. The level of concentration in railroad market is extremely high by any standard.
- The market power of the railroads was reinforced by the failure of the ICC/STB to prevent railroad conduct that undermined competition. The anticompetitive practices have been well documented for years, including practices such as paper barriers, cancellation of interconnection agreements, and refusal to quote bottleneck rates or to allow access to bottleneck facilities.
- As a result, a significant part of bulk commodities have been rendered substantially captive to the rails. Coal is by far the most captive commodity with as much as two-thirds captive to a single railroad. Other commodities that have high levels of captivity are chemicals and agricultural commodities.

Failing to implement the captive shipper protections of the Staggers Act, the ICC/STB has allowed the railroads to abuse this market power.

- Profits of railroads that carry more than half the traffic in the U.S. exceed their cost of capital. This means that shippers are being overcharged by $1 billion per year.

- The excess profits have existed for several years on specific railroads and are the result of pricing power exercised by the rails.

- Wall Street analysts project that the pricing power will persist and drive up prices and earnings over the next several years.

Significant quantities of traffic are carried by the rails at non-compensatory rates, violating the Staggers Act and increasing the burden on captive shippers.

- Approximately one-fifth of all traffic does not cover its variable costs, resulting in a cross-subsidy from captive shippers of over $2 billion per year.

- This increases the burden on captive shippers because it distorts the revenue adequacy status of the railroads.

As a result of the excessive profits and non-compensatory traffic, rates for captive shippers are higher than they should be about $3 billion per year. The productive and allocative inefficiency in the rail sector imposes inefficiencies on the broader economy because rail service is an infrastructural service on which other economic sectors are dependent. Inefficiency in the rail sector distorts shipper decisions about which fuels to burn and which plants to operate, which raises costs and reduces employment. It drives some freight traffic onto the highways, adding to congestion and wear-and-tear on the roads.

THE STB COMPETITION ANALYSIS

The recent STB report, entitled *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition,* is a stark reminder that captive shippers cannot expect a fair and balanced hearing from the STB. The analysis suffers from a series of flaws and blind spots.

The report fails to analyze the nature and extent of captivity that exists in the rail industry.

- For example, in an almost thousand-page document, the most important facts with respect to competition – that two-thirds (66 percent) of coal carried by the rails, over half of all corn (53 percent) and one-third (33 percent) of chemical shipments are delivered to facilities that are served by only on railroad – are buried in a footnote half way through the text. There is a high probability that these shipments are captive, but the study provides no analysis of them and fails to define the geographic level properly for competitive analysis.

- The rates charged on captive traffic in comparison to non-captive shipments are not discussed.

- The status of competition at the origin of these shipments is never analyzed, nor is the extent of captivity at origins discussed in detail.

Although the pricing analysis presented deals with comparisons between hypothetical competitive situations, it still shows that captive shippers pay much higher rates than shippers who enjoy competitive alternatives.

- Coal delivered to facilities in counties that are served by only one railroad pay about 32 percent more than shippers in counties where two railroads deliver equal amounts of coal to the facility and 59 percent more than shippers in counties where there are three shippers delivering equal quantities of coal to the facility.

- Captivity on the originating end had less of an impact – with shippers in counties served by one railroad paying 6 percent more than origins served by two railroads of equal market shares and 10 percent more than origins with three railroads having equal market shares.

The study locates the vast majority of its analysis at the wrong level. The key policy questions before the STB and the Congress involve specific commodities in specific markets served by specific commodities, specific markets or specific railroads. The competition study devotes most of its attention to the industry as a whole, rather than specific commodities, specific markets or specific railroads. This is a classic case where the average for the industry thoroughly misleads the policy maker. For example, the study concludes that "Rates on average need to be marked up over marginal cost by about 70 percent to achieve revenues sufficient to cover cost" (p. 18-35). Even with this figure that is based on a methodology that overstates the cost of capital substantially,

- Two of the major national railroads (the Burlington Northern (BNSF) and the Norfolk Southern (NS) are well above that figure.

- The same two railroads have had a return on equity that far exceeded their cost of capital as calculated by the STB in 2005. For the BN, the return on equity was almost twice the cost of capital, while for the NS it was almost 1.5 times the cost of capital.

The study also shows that a large amount of traffic carried by the rails – one fifth – does not cover its variable cost. This means that if this traffic were shed, the profit of the railroads would increase. This represents a substantial inefficiency that suppresses the income of the railroads and increases the burden on captive shippers, in violation of the explicit language of the Staggers Act.

- The railroads that are not revenue-adequate might be so, if they shed this non-compensatory traffic or raised the rates it pays. Those that are exceeding their cost of capital would do so by an even larger margin if they shed this non-compensatory traffic or raised the rates that it pays.

- Differential pricing in excess of what is necessary has resulted in excess profits and massive cross-subsidies, which means captive shippers are being abused. The report glosses over the central reality of the rail industry.

- Captive shippers are forced to suffer higher rates because of the persistent inefficiency embodied in this traffic. Justice delayed is justice denied. More than a quarter of a century after the passage of the Staggers Act, captive shippers have a right to demand that regulators no longer allow this inefficiency to burden traffic captive shippers. The STB has failed to address this problem, in violation of the Staggers Act, and its competition analysis ignores this problem entirely,

The discussion of revenue adequacy is inadequate in other ways. The STB has adopted a definition of revenue adequacy after years of controversy.

- The study also cites a single 2004 Wall Street analysis that notes that the rails had just reached an adequate return, but makes no effort to look at more recent years, yet if several railroads were at or above revenue adequacy in 2005, they were likely well above it in the last couple of years because prices and profits have been rising sharply.

- There are numerous other Wall Street analyses that show that in recent years rail returns have exceeded their cost of capital and that rates continue to rise rapidly.

- These Wall Street analyses project that rates are likely to continue to rise as a result of the pricing power the railroads have achieved through mergers and the elimination of spare capacity.

Our analysis, designed to give a balanced view of the structure, conduct and performance of the rail industry since the passage of the Staggers Act fills many of the holes in the STB analysis.

POLICY RECOMMENDATIONS

This review of the state of the rail freight industry demonstrates that the mergers of the mid-1990s have created a highly concentrated market structure in which neither intramodal competitive forces within the rail sector nor intermodal competition from trucks and water transport is sufficient to discipline the abuse of market power. Anticompetitive conduct has further weakened competition by undermining interline traffic. The STB has done little, if anything, to prevent or diminish this abuse. With captive shipper rates and rail profits escalating rapidly the harm to consumers, shippers and the economy is mounting rapidly. The need to address this growing national problem is urgent.

The STB has failed to implement the captive shipper and procompetitive provisions of the Stagger Act to protect the public. We identified this central problem over a quarter of a century ago. It has festered ever since and, as we show in this analysis, now costs consumers billions of dollars per year.

The consumer protection and pro-competitive provisions of the Staggers Act, which the STB has failed to implement properly, should be brought back to life with legislation to fill their proper function. Legislation is necessary because the regulators have failed to properly implement these provisions for a quarter of a century. There is no prospect that the STB is willing or able to correct the problem on its own.

Removing Barriers to Competition

First, since competition is the best form of consumer protection, we begin by describing the policy changes necessary to reinvigorate rail-to-tail competition. After a quarter of a century in which competition has shriveled in the industry, the provisions of existing law that protect the railroads from vigorous antitrust enforcement must be eliminated.

Antitrust Law: Lifting the exemption from the antitrust laws will immediately expose the most blatantly anticompetitive practices, like paper barriers to pressures for their elimination. These artificial barriers to competition, imposed by the railroads to ensure they would be able to exercise the market power accumulated through mergers, should fall by the wayside quickly. The permanent structural barriers to competition posed by terminal and bottleneck facilities will also come under scrutiny, but these are likely best dealt with under a repaired regulatory structure at the STB.

Stagger Act Access to Bottlenecks: The existing statute provides for terminal trackage rights without showing "competitive abuse." The ICC invented the "competitive abuse" and shifted the emphasis away from promoting competition, which was the intention of the act statute. That test should be eliminated, so that Congressional intent to promote a competitive and efficient rail industry is fostered.

The STB created a statutory concept out of whole cloth, ruling that rails do not have to quote "bottleneck rates" unless a shipper has a contract from a railroad that could serve the shipper if the shipper is quoted the "bottleneck rate." Of course, shippers universally cannot get such contracts, so the STB's ruling stifled competition and produced inefficiency. In essence the STB rule reinforced the incentive to refuse to quote competitive rates and became an ideal tool to implement parallel, anticompetitive action. The STB's ruling should be overturned by requiring rails to quote "bottleneck rates."

Preventing the Abuse of Endemic Market Power

Second, policy makers should be under no illusions about the pervasiveness of market power. The highly concentrated market structure and substantial physical barrier to entry mean that even where the artificial, conduct-based impediments to competition are removed, there will be a great deal of market power remaining in the sector. Thus, regulatory oversight to effectively protect captive shippers from abuse will still be necessary.

Rate Threshold: No other regulatory agency uses the "stand-alone cost" test. It is ludicrous that a captive shipper should have to pay several millions of dollars just to challenge a rail rate, and that a railroad has to spend several millions of dollars to defend the rate. The SAC test was adopted in 1985 to permit railroads to charge the highest rates economists could justify, due to the rails' then-revenue inadequacy and then-excess capacity. Those justifications no longer apply, so there is no justification for the SAC test, if there ever was. It should be repealed. With unchallenged market power and enduring captivity, the STB should return to a rate standard based on cost plus a reasonable return. The railroads should bear the burden of proving that rates above the threshold of 180 percent of variable cost are reasonable, including a showing that all traffic is compensatory.

Cost of Capital: The STB has consistently overstated the cost of capital, allowing the rails to abuse their market power and earn excess profits. The STB did adopt new cost-of-capital rules to rely on the so-called "CAPM" methodology, rather than the largely discredited discounted cash flow ("DCF") methodology, to measure the railroads' cost of capital. It then almost immediately backtracked, adopting a revised formula using 50 percent CAPM and 50 percent DCF to determine the cost of capital. Still, the new rules demonstrate that the STB's old methodology of using only the DCF measure of the cost of capital substantially overstated the railroads' cost of capital and therefore led to the unwarranted conclusion that virtually no railroads were revenue-adequate for most of the last 30 years. The STB did reject the railroads' petition to adopt a replacement-cost methodology rather than a net-investment methodology for determining the asset base for revenue-adequacy determinations, but the railroads continue to advocate for replacement costs at both the STB and before Congress. No regulatory agency in the United States, for any regulated industry, uses a replacement-cost methodology to determine either revenue adequacy or maximum reasonable rates. The STB should use the CAPM model and Congress will have to be vigilant to prevent the use of replacement costs to determine either revenue adequacy or a maximum reasonable rail rate.

Small Shippers: Also, the STB's "small-shipment" rate-challenge rules – to be used when the SAC test is not available (due to the absence of sufficient volumes to allow it to work -- have artificial limits on relief ($1 million over 5 years, or $5 million over 5 years, depending on whether the "three-benchmark" methodology, or the so-called "simplified stand-alone cost" methodology, is used). There is no justification for those artificial limits on relief. Those limits appear to have limited the number of cases filed to two (by DuPont and US Magnesium). Small shippers apparently cannot justify the large transaction costs (hundreds of thousands, perhaps 500 hundred thousand, dollars) just to present such a case.

With the prospect of, at most, only $1 million in relief over 5 years, that is too risky to justify. Apparently, no one really knows how the so-called "small-shipment" rate-case guideline would work, or if it would work, so no shipper has filed a case under that test. So, the STB "small-shipment" rate-case guidelines appear largely unavailable and too expensive to produce meaningful relief.

Once the statute is amended to compel the STB to provide captive shippers the protections that the Staggers Act intended, the agency will require adequate funding and staff to implement those protections effectively.

OUTLINE

The remainder of Part I describes the structure, conduct, performance approach to the analysis of industrial organization, which is used in this analysis. This paradigm has been the dominant approach to analysis of industrial organization for almost a century and it pinpoints the key issues in the rail industry.

Part II discusses the structure and conduct of the rail industry since the passage of the Staggers Act. Section III describes the sweeping changes in rail market structure and conduct that have taken place in the past two decades. Section IV discusses basic conditions that have created the opportunity for the railroads to increase the exercise of their market power. These recent rail market developments have triggered the growing calls to rein in rail abuse.

Part III examines the performance of the rail industry in the past decade. Section V examines broad patterns of price increases at the national level, which provide evidence of the abuse of market power. Section VI shows that these abuses are even more pronounced when examined in specific product and geographic markets. Section VII reviews quality of service issues. Section VIII shows that the railroads are not only revenue adequate, but are earning excessive returns and engaging in substantial cross subsidization. Section IX discusses policies to correct the problem.

II. ANALYTIC FRAMEWORK

DEFINITIONS AND CONCEPTS

This analysis relies on the structure, conduct performance (SCP) view of industrial organization and economic activity, which "provides a useful framework for organizing and discussing a number of important concepts."[15] It has been the dominant public policy paradigm in the United States for the better part of a century.[16] Figure II-1 present two graphic representation of the SCP framework from two prominent economic texts. The key elements of the paradigm that will be discussed below are highlighted in both of the Figures.

The central concern in the paradigm is with market performance, since that is the outcome that affects consumers most directly. The concept of performance is multifaceted. It includes, among other factors, productive and allocative efficiency, progress, and fairness.[17] The measures of performance to which we traditionally look are pricing and profits. They are the most direct measure of how society's wealth is being allocated and distributed.[18]

The performance of industries is determined by a number of factors, most directly the conduct of market participants.[19] Do they compete? What legal (or illegal) tactics do they employ? How do they advertise and price their products? The fact that conduct is only part of the overall analytic paradigm is important to keep in mind.

Conduct is primarily a product of other factors.[20] Conduct is affected and circumscribed by market structure. Here we look at the number and size of the firms in the

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[15] Viscusi, Kip, W. John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge: MIT Press, 2001), p. 62.

[16] Scherer and Ross 1990, p. 4.: We seek to identify sets of attributes or variables that influence economic performance and to build theories detailing the nature of the links between these attributes and end performance. The broad descriptive model of these relationships used in most industrial organization studies was conceived by Edward S. Mason at Harvard during the 1930s and extended by numerous scholars.

[17] F. M Scherer and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifling: Boston, 1990) (hereafter Scherer and Ross), p. 4.

[18] Scherer and Ross 1990, p. 4: We begin with the fundamental proposition that what society wants from producers of goods and services is good performance. Good performance is multidimensional… Decisions as to what, how much and how to produce should be efficient in two respects: Scarce resources should not be wasted, and production decisions should be responsive qualitatively and quantitatively to consumer demands.

The operations of producers should be progressive, taking advantage of opportunities opened up by science and technology to increase output per unit of input and to provide consumers with superior new products, in both ways contributing to the long-run growth of real income per person. The operation of producers should facilitate stable full employment of resources… The distribution of income should be equitable. Equity is notoriously difficult to define, but it implies at least that producers do not secure rewards in excess of what is needed to call forth the amount of services supplied.

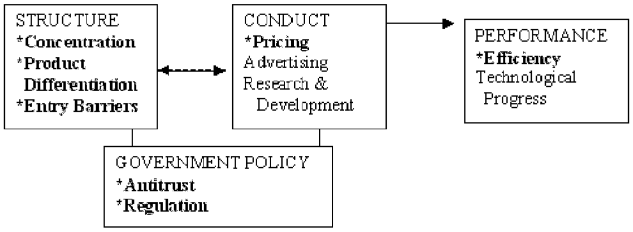
[19] Scherer and Ross 1990 p. 4: Performance in particular industries or markets is said to depend upon the conduct of sellers and buyers in such matters as pricing policies and practices, overt and taciturn interfirm cooperation, product line and advertising strategies, research and development commitments, investment in production facilities, legal tactics (e. g. enforcing patent rights), and so on.

[20] Scherer and Ross 1990, p. 5: Conduct depends in turn upon the structure of the relevant market, embracing such features as the number and size distribution of buyers and sellers, the degree of physical or subjective differentiation prevailing among competing seller's products, the presence or absence of barriers to entry of new firms, the ratio of fixed to total costs in the short run for a typical firm, the degree to which firms are vertically integrated from raw material production to retail distribution and the amount of diversity or conglomerateness characterizing individual firms' product lines.

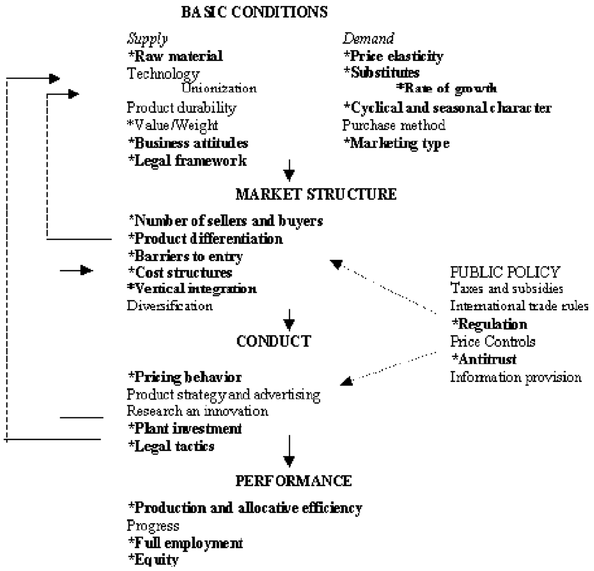
Market structure and conduct are also influenced by various basic conditions. For example, on the supply side, basic conditions include the location and ownership of essential raw materials; the characteristics of the available technology (e.g. batch versus continuous process productions or high versus low elasticity of input substitution); the degree of work force unionization; the durability of the product; the time pattern of production (e.g. whether goods are produced to order or delivered from inventory); the value/weight characteristics of the product an so on. A list of significant basic conditions on the demand side must include at least the price elasticity of demand at various prices; the availability of (and cross elasticity of demand for) substitute products; the rate of growth and variability over time industry, their cost characteristics and barriers to entry, as well as the basic conditions of supply and demand.

Figure II-1: The Structure-Conduct-Performance Model of Industrial Organization

Viscusi, Kip, W. John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* **(Cambridge: MIT Press, 2001), p. 62.**



F. M Scherer and David Ross, *Industrial Market Structure and Economic Performance* **(Houghton Mifling: Boston, 1990) (hereafter Scherer and Ross), p. 5.**



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of demand; the method employed by buyers in purchasing (e.g. acceptance of list prices as given versus solicitation of sealed bids versus haggling); and the marketing characteristics of the product sold (e.g. specialty versus convenience shopping method).

Regardless of how much weight one gives to the causal assumptions of the paradigm, the list of variables is important. These are the factors that taken together determine whether markets work or fail.[21] Also note that the paradigm contemplates the possibility that structure and behaviors affect basic conditions.[22] There are feedback effects in the model and policy plays a key role in the paradigm. Antitrust and regulation are central factors.

The theoretical concepts in the framework are challenging empirically. Pure and perfect competition is rare, but the competitive goal is important.[23] Therefore, a great deal of attention has been focused on the relative competitiveness of markets and conditions that make markets more competitive or workably competitive. Summarizing an "explosion of articles on workable competition" Scherer and Ross developed a list of "the criteria of workability suggested especially frequently by diverse writers [that] can be divided into structural, conduct and performance categories.[24] The list is presented in Figure II-2, verbatim from the text. Again, the items that will be discussed below are highlighted.

As we shall see, the number of rails has shrunk and their size has grown so large that it is doubtful that the first structural condition on minimum efficient scale is being met. There is a clear and growing pattern of artificial inhibitions on mobility and entry, in addition to natural barriers to entry that are huge. Thus the second structural condition is being violated. The conduct conditions for workable competition are also widely violated. Participants in the industry have begun to signal their pricing intentions with published tariffs to diminish price competition and there is a pervasive pattern of exclusionary tactics and harmful price discrimination. In the performance area, there is substantial inefficiency, poor service quality and excess profits, as well as a lack of responsiveness to consumer demand.

Efficiency

The efficiency outcome is so central to the paradigm that it deserves more detailed discussion. The focal point of market structure analysis is to assess the ability of markets to support competition, which "has long been viewed as a force that leads to an ideal solution of the economic performance problem, and monopoly has been condemned."[25] The predominant reason for the preference for competitive markets reflects the economic performance they generate, although there are political reasons to prefer competitive markets as well.[26] In particular, competition fosters efficient allocation of resources, absence of excess profit, lowest cost production and provides a strong incentive to innovate.[27] Where competition breaks down, firms are said to have market power and the market falls short of the desired efficient results.[28]

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[21] Scherer and Ross 1990, p. 6.

[22] Scherer and Ross, p. 6.: As the solid arrows of Figure 1.1 suggest, we shall be concerned mainly with causal flows running from market structure and/or basic conditions to conduct and performance. That is, we seek theories that permit us to predict ultimare market performance from market structure, basic conditions, and conduct…

There are also important feedback effects (dashed arrows in Figure 1.1). For instance, vigorous research and development efforts can alter an industry's technology, and hence it cost conditions and/or the degree of physical productions differentiation. Or sellers' pricing policies may either encourage or discourage entry or drive firms out of the marker, thereby transforming the dimension of market structure. In this sense, both basic conditions and market structure variables are *endogenous*, that is determined within the whole system of relationships and not fixed by outside forces

[23] Scherer and Ross 1990, p. 16-17.

[24] Scherer and Ross 1990, p. 53.

[25] Scherer and Ross 1990, p. 15.

[26] Scherer and Ross 1990, p. 18.

Figure II-2: Criteria of Workable Competition

STRUCTURAL CRITERIA

***The number of traders should be at least as large as scale economies permit.**
***There should be no artificial inhibitions on mobility and entry.**
There should be moderate and price-sensitive quality differentials in products offered.

CONDUCT CRITERIA

***Some uncertainty should exist in minds of rivals as to whether price initiatives will be followed.**
Firms should strive to attain their goals independently, without collusion.
***There should be no unfair, exclusionary, predatory, or coercive tactics.**
*** Inefficient suppliers and customers should not be shielded permanently.**
Sales promotions should be informative, or at least not misleading.
***There should be no persistent, harmful price discrimination.**

PERFORMANCE CRITERIA

*** Firms' production and distribution operations should be efficient and not wasteful of resources.**
***Output levels and product quality (that is variety, durability, safety, reliability, and so forth) should be responsive to consumer demands.**
***Profits should be at levels just sufficient to reward investment, efficiency, and innovation.**
***Prices should encourage rational choice, guide markets toward equilibrium, and not intensify cyclical instability.**
Opportunities for introducing technically superior new products and processes should be exploited.
Promotional expenses should not be excessive.
Success should accrue to sellers who best serve consumer wants

Source: F. M Scherer and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifling: Boston, 1990) (hereafter Scherer and Ross), p. 53-54).

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[27] Scherer and Ross 1990, p. 4, 20.
[28] Scherer and Ross 1990, p. 17-18.

> In modern economic theory, a market is said to be competitive (or more precisely purely competitive) when the number of firms selling a homogeneous commodity is so large, and each individual firm's share of the market is so small, that no individual firm finds itself able to influence appreciably the commodity price by varying the quantity of output it sells.... Pure monopolists, oligopolists, and monopolistic competitors share a common characteristic: each recognizes that its output decision have a perceptible influence on price, or in other words, each can increase the quantity of output it sells under given demand conditions only by reducing its price. All three types possess some degree of power over price, and so we say that they possess *monopoly power* or *market power.*
>
> Homogeneity of the product and insignificant size of individual seller and buyers relative to their market (that is *atomistic* market structure) are sufficient conditions for the existence of pure competition... Several additional structural conditions are added to make competition in economic theory not only "pure" but "perfect." The most important is the absence of barriers to entry of new firms, combined with mobility of resources employed.[29]

The competitive marketplace exhibits three desirable economic efficiency characteristics.

> The long-run equilibrium state of a competitive industry has three general properties with important normative implications: The cost of producing the last unit of output—is equal to the price paid by consumers for the unit... With price equal to average total cost for the representative firm, economic (that is, supra-normal) normal profits are absent... In the long-run equilibrium, each firm is producing its output at the minimum point on its average total cost curve.[30]

The discussion of efficiency criteria can be related directly to the rail industry. Because the railroad industry has high fixed costs, the first condition, analyzed as marginal cost equals price, cannot hold if the industry is to be economically viable. The prices it charges must not only cover (equal) marginal (or variable) costs, they must also cover the capital costs to deploy and maintain the physical plant necessary to provide the service. There must be a mark-up of prices above marginal costs. Price should equal average total cost, which is higher than marginal cost in the case of the rail industry. In practical terms, the revenue-to-variable cost ratio (R/VC) must be greater than 1.

While the first condition needs to be framed properly for the rail industry, the second and third conditions can apply directly. The second condition, the mark-up of prices above costs, should allow the railroads to earn a normal return on capital without including any supra normal profits. Here the rail industry goes astray. It is generally agreed that the railroads must mark up prices by 30 to 50 percent above variable costs to cover their cost of capital. In other words, the second condition is met when R/VC = 1.3 to 1.5 (when the proper cost of capital is used, as opposed to the STB's inflated cost of capital). The revenue-to-variable cost ratios for several of the railroads exceed the level necessary to cover cost. We can observe directly whether railroads are earning supra-normal (or excess profits) by comparing their return on equity to the market cost of equity capital.

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[29] Scherer and Ross, 1990, 15, 16, 17.

[30] Scherer and Ross, 1990, 20.

The third condition can also be met. A railroad can operate at a point where average total costs are minimized and all traffic covers its marginal cost. If the railroad is operating at a level above the average total cost minimum in a range where average total costs are greater than marginal costs, it should lower prices and expand output. If the railroad is operating in an area where average total costs are above the minimum in a range where marginal costs are above average costs, it should raise prices and lower output. Here too, the railroads have missed the mark to the detriment of captive shippers. Railroads are cross-subsidizing competitive traffic and failing to maximize contribution to fixed costs on this traffic as required by the Staggers Act.

Given that the railroads carry a mix of traffic that has various costs and face different levels of competition, we would expect to see different movements with different revenue-to-variable cost ratios. Differential pricing is inevitable. However, these three conditions combine to define a clear performance outcome that is efficient. Where the firm does not earn excess profits and all traffic is compensatory, the revenue-to-variable cost ratio on captive traffic will not be excessive. This will not happen as a result of market forces, however. Where market power exists, railroads have incentives to increase rates on captive traffic to increase profits and under some circumstances cross-subsidize more competitive traffic. Regulation is supposed to prevent this outcome, which is both inefficient and inequitable.

Lax regulation has allowed the contemporary rail industry to violate both the excess profit and the total cost conditions. Some railroads are earning a return on equity that is above the market return on equity capital and they are carrying a substantial amount of traffic that does not cover its marginal cost. In other words, the railroads are overcharging some (captive) shippers and undercharging other shippers. The burden falls on captive shippers who are paying rates that are on average almost 30 percent higher than they should be.

The analysis of efficiency should not only focus on efficiency within the rail sector. Because transportation is an infrastructural service, a vital input that affects a broad range of economic activity, distortions within the rail sector affect the economic activities that rely on it.[31] CFA identified this problem with respect to the electricity sector early in the debate over abuse of market power by the rails.

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[31] Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (Cambridge: MIT Press) p. 11.

> Inefficiency in railroad operations is sustained and supported by the unrestrained ability to exercise monopoly power. Choices about generating capacity and sources of energy may be distorted by the distortions of transportation costs. Inefficient allocation of resources within the economy results from the transfer of wealth from consumers to rail stockholders.[32]

Recent theoretical analysis confirms that this broader perspective must be brought to bear on the issue.

> The purpose of this paper is to study how the deregulation of the transport sector affects social welfare once it is recognized that firms and mobile agents are free to relocate in the long-run response to permanent changes in freight rates and consumer prices. Our key result is to show that *there is a trade-off between short run benefits and long run losses; in* the short run, transport deregulation reduces static deadweight losses arising from marker power in both the transport and manufacturing sector; but in the long run, it generates deadweight losses because of sub-optimal redistribution of industrial activity across regions.[33]

Recent empirical evidence suggests that the problem persists and has spread to other sectors as railroad abuse of market power had increased. There is a range of distortions beyond the shift of resources from consumers and captive shippers to rail owners, including shifts in fuel choices, transportation sources used, and decisions about plant location.

ANALYZING MARKET STRUCTURE: MEASURING MARKET CONCENTRATION

With the efficient results created by competition as the focal point of the overall analysis, it is natural that the central concern in describing markets is to analyze the state of competition. The number and size of firms in the market becomes the launch point for much analysis in an effort to ascertain whether a small number or an "individual firm finds itself able to influence appreciably the commodity price by varying the quantity of output it sells."

Measuring concentration for purposes of market structure analysis has received a great deal of attention. Market structure analysis is used to identify situations where a small number of firms control a sufficiently large part of the market as to make coordinated or reinforcing activities feasible. Where monopoly exists, the ability to influence price is likely present, especially for commodities that have few substitutes. Monopoly is not the only circumstance under which power over price can exist. Through various implicit and explicit mechanisms, a small number of firms can reinforce each other's behavior, rather than

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[32] Cooper, Mark. 1985a. The Consumer Impact of the Unregulated Railroad Monopoly in Coal Transportation. *Subcommittee on Monopolies and Commercial Law of the Judiciary Committee, U.S. House of Representatives*, June 27, p. 4.

[33] Behrens, Kristian, Gaigne, Carl and Thisse, Jacques-François, 2007, *Is the Regulation of the Transport Sector Always Detrimental to Consumers?*. Center for Economic Policy Research, Discussion Paper No. DP6185, March

Available at SSRN: http://ssrn.com/abstract=1133829

compete.[34] The opening section of the Department of Justice Merger Guidelines states the issue as follows:

> Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time.*/ In some circumstances, a sole seller (a "monopolist") of a product with no good substitutes can maintain a selling price that is above the level that would prevail if the market were competitive. Similarly, in some circumstances, where only a few firms account for most of the sales of a product, those firms can exercise market power, perhaps even approximating the performance of a monopolist, by either explicitly or implicitly coordinating their actions. Circumstances also may permit a single firm, not a monopolist, to exercise market power through unilateral or non-coordinated conduct – conduct the success of which does not rely on the concurrence of other firms in the market or on coordinated responses by those firms. In any case, the result of the exercise of market power is a transfer of wealth from buyers to sellers or a misallocation of resources.
>
> */ Sellers with market power also may lessen competition on dimensions other than price, such as product quality, service or innovation.[35]

Identification of when a small number of firms can exercise market power is not a precise science. Generally, however, when the number of significant firms falls into the single digits, there is cause for concern.

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[34] Lawrence Sullivan and Warren S. Grimes, *The Law of Antitrust: An Integrated Handbook,* Hornbook Series (West Group, St. Paul, 2000), at 596-597: The coordination that can produce adverse effects can be either tacit or express. And such coordination need not be unlawful in and of itself. According to the 1992 Guidelines, to coordinate successfully, firms must reach terms of interaction that are profitable to the firms involved and be able to detect and punish deviations. The conditions likely to facilitate these two elements are discussed separately, although they frequently overlap.

In discussing how firms might reach terms for profitable coordination, the Guidelines avoid using the term "agreement," probably because no agreement or conspiracy within the meaning of Section 1 of the Sherman Act is necessary for the profitable interaction to occur. As examples of such profitable coordination, the Guidelines list "common price, fixed price differentials, stable market shares, or customer or territorial restrictions." Sometimes the facilitating device may be as simple as a tradition or convention in an industry.

The rule of thumb reflected in all iterations of the Merger Guidelines is that the more concentrated an industry, the more likely is oligopolistic behavior by that industry... Still, the inference that higher concentration increases the risks of oligopolistic conduct seems well grounded. As the number of industry participants becomes smaller, the task of coordinating industry behavior becomes easier. For example, a ten-firm industry is more likely to require some sort of coordination to maintain prices at an oligopoly level, whereas the three-firm industry might more easily maintain prices through parallel behavior without express coordination.

Oligopoly conditions may or may not require collusion that would independently violate Section 1 of the Sherman Act. A supracompetitive price level may be maintained through price leadership (usually the leader is the largest firm), through observance of a well-established trade rule (e.g., a convention of a 50 percent markup in price among competing retailers), or through strategic discipline of nonconforming members of the industry. The most common form of such disciplining action is the price war, instituted to prevent any member from gaining market share at the expense of the others. An industry characterized by two-level pricing-a higher level of pricing that normally prevails but is interrupted by occasional price wars-may be exercising this oligopolistic behavior. The price war is aimed at discouraging industry participants from abandoning price discipline.

[35] U.S. Department of Justice 1997, section 0.1.

> Where is the line to be drawn between oligopoly and competition? At what number do we draw the line between few and many? In principle, competition applies when the number of competing firms is infinite; at the same time, the textbooks usually say that a market is competitive if the cross effects between firms are negligible. For up to six firms one has oligopoly, and with fifty firms or more of roughly equal size one has competition; however, for sizes in between it may be difficult to say. The answer is not a matter of principle but rather an empirical matter.[36]

The clear danger of a market with a structure equivalent to only six equal-sized firms was recognized by the Department of Justice in its Merger Guidelines. These guidelines were defined in terms of the Herfindahl-Hirschman Index (HHI). This measure takes the market share of each firm, squares it, sums the result and multiplies by 10,000.[37]

A market with six equal-sized firms would have an HHI of 1667. The Department declared any market with an HHI above 1800 to be highly concentrated. Thus, the key threshold is at about the equivalent of six or fewer firms (see Figure II-3).

Another way that economists look at a market at this level of concentration is to consider the market share of the largest four firms (called the 4-Firm concentration ratio). In a market with six equal sized firms, the 4-Firm concentration would be 67 percent. The reason that this is considered an oligopoly is that with a small number of firms controlling that large a market share, their ability to avoid competing with each other is clear.

Shepherd describes this threshold as follows: "Tight Oligopoly: The leading four firms combined have 60-100 percent of the market; collusion among them is relatively easy" (Shepherd, 1985, p. 4).

While six is a clear danger sign, theoretical and empirical evidence indicates that many more than six firms are necessary for atomistic competition – perhaps as many as fifty firms are necessary. Reflecting this basic observation, the Department of Justice established a

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[36] Friedman, J.W. 1983. *Oligopoly Theory.* Cambridge: Cambridge University Press, p. 8-9

[37] Shepherd1985, p. 389, gives the following formulas for the Herfindahl-Hirschman Index (HHI) and the four Firm Concentration Ratio (CR4):

$$H = \sum_{i=1}^{n} S_i^2$$

$$CR4 - \sum_{i=1}^{n-4} S_i$$

where
n = the number of firms
S_i – the share of the ith firm.

Figure II-3: Describing Market Structures

Department of Justice Merger Guidelines Concentration	**Type of Market**	**Equivalents In Terms of Equal Sized Firms**	**Typical HHI in Media Markets**	**4-Firm Share**
	Monopoly	1[a]	5300+	~100
	Duopoly	2[b]	3000 - 5000	~100
	Dominant Firm	4<	>2500	
		5	2000	80
			1800	60
		6	1667	67
High				
Moderate	Tight Oligopoly			60
Unconcentrated	Loose Oligopoly	10	1000	40c
	Monopolistic Competition			
	Atomistic Competition	50	200	8[c]

a = Antitrust practice finds monopoly firms with market share in the 65% to 75% range. Thus, HHIs in "monopoly markets can be as low as 4200.

b = Duopolies need not be a perfect 50/50 split. Duopolies with a 60/40 split would have a higher HHI.

c = Value falls as the number of firms increases.

Sources: U.S. Department of Justice, *Horizontal Merger Guidelines*, revised April 8, 1997, for a discussion of the HHI thresholds; William G. Shepherd, *The Economics of Industrial Organization* (Englewood Cliffs, NJ: Prentice Hall, 1985), for a discussion of four firm concentration ratios. J. W. Friedman, 1983. *Oligopoly Theory*. Cambridge: Cambridge University Press.

second threshold to identify a moderately concentrated market. This market was defined by an HHI of 1000, which is equivalent to a market made up of 10 equal sized firms. In this market, the 4-Firm concentration ratio would be 40 percent.

Shepherd describes this threshold as follows: "Loose Oligopoly: The leading four firms, combined, have 40 percent or less of the market; collusion among them to fix prices is virtually impossible" (Shepherd, 1985, p. 4).

Shepherd also notes that a dominant firm – "one firm has 50-100 percent of the market and no close rival" – is even more of a concern (Shepherd, 1985, p. 4).

Even the moderately concentrated threshold of the Merger Guidelines barely begins to move down the danger zone of concentration from 6 to 50 equal sized firms. Mergers between firms that result in markets that are moderately or highly concentrated raise concerns.

> b) Post-Merger HHI Between 1000 and 1800. The Agency regards markets in this region to be moderately concentrated… Mergers producing an increase in the HHI of more than 100 points in moderately concentrated markets post-merger potentially raise significant competitive concerns depending on the factors set forth in Sections 2-5 of the Guidelines.
>
> c) Post-Merger HHI Above 1800. The Agency regards markets in this region to be highly concentrated…. Mergers producing an increase in the HHI of more than 50 points in highly concentrated markets post-merger potentially raise significant competitive concerns…. it will be presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise.[38]

These thresholds have been chosen based on theory, empirical evidence and experience with the exercise of market power. In a seminal 1981 *Harvard Law Review* article, William Landes and Richard Posner, two of the leading Chicago School law and economics practitioners, argued that antitrust authorities should take market fundamentals into account. In assessing the potential impact of market power, "the proper measure will attempt to capture the influence of market demand and supply elasticity on market power" (Landes and Posner 1981, p. 947). Landes and Posner focus on the most common indicator of market power, the Lerner index, which measures the extent to which prices are marked up over costs. "We point out that the Lerner index provides a precise economic definition of market power, and we demonstrate the functional relationship between market power on the one hand and market share, market elasticity of demand, and supply elasticity of fringe competitors on the other."[39]

The Lerner Index measures the first efficiency condition discussed above – the mark-up of price over cost.

$$L = \frac{(P - C)}{P}$$

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[38] DOJ, Merger Guidelines, Section 1.5.

[39] Richard Schmalensee, *Another Look At Market Power* 95 HARV. L. REV. 1789, 1797 (1982); p. 938

> [T]he *Lerner Index [*is] defined as: "[L] = (Price – Marginal Cost)/ Price…Its merit is that it directly reflects the allocatively inefficient departure of price from marginal cost associated with monopoly. Under pure competition, [L]=0. The more a firm's pricing departs from the competitive norm, the higher the associated Lerner Index value. A related performance-oriented approach focuses on some measure of the net profits realized by firms or industries."[40]

The Lerner Index is frequently expressed as the inverse of the elasticity of demand:

$$L= \frac{(P-C)}{P} = \frac{1}{E^d}$$

where:

e^d_m = elasticity of demand in the market

An improvement was suggested in which the Lerner index was related to a measure of the overall market concentration – the HHI.[41] Importantly, the Lerner Index is equal to the HHI divided by the elasticity of demand.

$$L = \frac{HHI}{E_d} = \frac{Sj2}{E_d}$$

e^s_j = elasticity of supply of the competitive fringe

s_i = market share of the fringe.

The HHI uses the market shares of all participants in the numerator of the fraction since oligopolists may not "compete."[42] This observation provides the explicit theoretical link between the HHI-based market structure analysis and the efficiency outcomes in which we are most concerned in the following discussion – mark-ups of price over cost and excess profits.

Landes and Posner rendered Lerner index in a somewhat different formulation.

$$L= \frac{(P-C)}{P} = \frac{1}{E^d} = \frac{S_i}{e^d_m + e^s_j\ (1 - S_i)}$$

where:

S_d = the market share of the dominant firm

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[40] Scherer and Ross 1990, pp. 70-71.

[41] A series of responses to the Landes and Posner article, were published in the *Harvard Law Review* the following year (Landes, William & Richard A. Posner, *Market Power in Anti-trust Cases*, 94 HARV. L. REV. 937, 953: (1981). These responses suggested limitations and improvements to the Landes and Posner approach. One of the main criticisms was that the authors were analyzing only the dominant firm market share in the numerator, when oligopolies are a more typical situation Janusz A. Ordover, Alan O. Sykes & Robert D. Willig, *Herfindahl Concentration, Rivalry, and Mergers*, 95 HARV. L. REV. 1863-1867 (1982).

[42] Other scholars argue that the formulation assumes Cornout oligopoly behavior. W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* at 149. (2000).

e^d_m = elasticity of demand in the market

e^s_j = elasticity of supply of the competitive fringe

s_i = market share of the fringe

In other words, this formula says that the markup of price over cost will be directly related to the market share of the dominant firm and inversely related to the ability of consumers to reduce consumption (the elasticity of demand) and the ability of other firms (the competitive fringe) to increase output (the elasticity of supply.)

Because Landes and Posner were arguing against a simplistic and mechanical focus on market share in market power analysis, they noted that their own formula should not be applied mechanically. They incorporated a number of traditional concerns by arguing that each of the terms in the equation should be defined to reflect other market characteristics in specific applications. Thus excess capacity, rather than simple market shares, barriers to entry, and long distance transport (such as a broad market definition), among other factors, should inform the analysis. On the demand side, substitutability (product definition) should be carefully examined. As discussed below, these four factors all point in the direction of greater abuse of market power in the rail industry.

Over the years, the competitive thresholds used by the DOJ/FTC have been debated. Some have argued that the thresholds are too strict. There is a thread in the literature that concludes that "four is few and six is many." Some even go farther, arguing that four is many. The rail industry is so highly concentrated that the debate between four and six firms as a threshold is largely irrelevant. For large segments of the rail industry, the number of options is considerably less than four.

REGULATION WHERE MARKET POWER IS ENDEMIC

Notwithstanding the aspiration for competition and the intention of merger policy to protect competition, there are situations where monopoly or concentrated markets exist and public policy attempts to ensure that the resulting market power is not abused to the detriment of the public and the economy. In the case of "natural" monopolies – like electric utilities – where is it believed that economies of scale will support only one firm or a very small number of firms and competition will not be vigorous, there is generally regulation of prices and service.

Even where regulation is in place, policies are frequently adopted that seek to promote competition in those elements of the service that do not exhibit large economies of scale. Such policies require nondiscriminatory interconnection and carriage and access to bottleneck facilities. Electricity and telecommunications are two network industries that exhibit this mix of regulation of monopoly services and policies to promote competition around the monopoly core of the sector.

Monopolies can also come into existence through the working of the marketplace. It is not illegal to win a monopoly through fair and open competition. It is, however, illegal to obtain a monopoly through anticompetitive behavior or mergers (except where the Congress permits tat outcome by suspending the antitrust laws, as has been the case in the rail sector). Even where a monopoly is obtained through legal means, once it exists, its behavior is closely scrutinized. It is illegal to do things that unfairly preserve the monopoly or to use the market power of the monopoly to raise prices or reduce service quality.

In essence, the accumulation of market power is deemed such an important economic problem that there are two broad sets of policy tools that seek to control and eliminate its harms – antitrust and regulation. Because of the aspiration for competition, the two main thrusts of economic policy often overlap where markets are highly concentrated and deliver vital infrastructural services. Market power is deemed so pervasive that regulation is necessary, but public policy recognizes that regulation is inevitably imperfect and may miss opportunities to promote competition. Thus, both regulation and the antitrust laws apply.

For the past 30 years as a practical matter, railroad market power has been excused from both aspects of this oversight. Claiming (hoping) that competition could be unleashed in the rail industry, Congress largely deregulated the key aspects of rail operations – pricing and abandonment of service. It preserved rate regulation only where "captivity" could be proven but the ICC/STB has implemented this in a manner that favors railroads at the expense of shippers and undermines competition between railroads.

The Staggers Act also continued and expanded rail industry exemptions from the full force of the antitrust laws. In addition to explicit exemptions, the Act also put the ICC/STB in charge of overseeing rail mergers, which confused the regulatory and antitrust roles. As a result, the industry has been allowed to become extremely concentrated and exhibit widespread anticompetitive practices and the abuse of market power, but shippers receive little regulatory protection from that abuse. Both regulation and antitrust have failed to do their jobs in the rail industry, in part because Congress was too exuberant about competition, in part because the regulators have been too protective of the railroads at the expense of captive shippers. After more than a quarter of a century, it is time to correct the mistakes.

PART II:

STRUCTURE AND CONDUCT: RAILROAD MARKET POWER

III. MARKET STRUCTURE, CONDUCT AND BASIC CONDITIONS IN THE RAIL INDUSTRY SINCE THE PASSAGE OF THE STAGGERS ACT

Economic theory predicts and empirical evidence confirms that the existence of market power in the rail industry, created by a series of mergers and anticompetitive practices, resulted in abusive pricing of rail services. While it was recognized that certain commodities would have to bear a larger share of the cost burden in order for the railroads to be economically viable, it was also acknowledged that the exercise of market power could be abusive.

The exercise of market power and the expression of discontent by captive shippers have been uneven across time, but it is particularly intense at present. The historical pattern of rail behavior and the explanations for it help to explain why the issue is now on the front burner.

In this chapter we review the broad patterns of change in rail market structure and conduct since the passage of the Staggers Act that have led to the repeated complaints of abuse of market power. The chapter begins where the discussion of the analytic framework left off, with the increases in market concentration as the foundation for the abuse of market power.

MERGERS CREATE A HIGHLY CONCENTRATED TIGHT OLIGOPOLY IN THE RAIL SECTOR

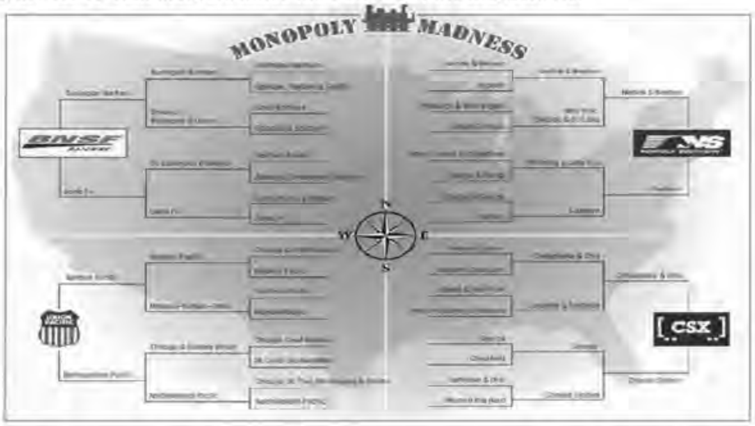
After the passage of the Staggers Act, the easy way to increase profitability was to exercise market power and raise prices where possible and seek to increase market power through mergers and anticompetitive behaviors. Rationalization of rail service, through abandonment of track and reduction in labor cost were initiated as well, but they take longer to produce results for the bottom line. Thus, in the mid-1980s captive shippers and consumers were concerned about rate increases and anticompetitive conduct. CFA pointed to the mergers and the anticompetitive practices as a problem.

> Approximately one out of four miles of merged track since the passage of the Staggers Act has meant the elimination of competition and parallel routes. The academic analyses of potential mergers has uniformly cautioned against parallel mergers because the increase in market power can offset efficiency gains...
>
> Similar concerns must be expressed over foreclosure of competitive options through cancellation or overpricing of joint rates, reciprocal switching, and other arrangements that facilitate access to competing rail carriers. Since the

passage of the Staggers Act, the dominant railroads have used their increased flexibility to close out movements that involve competing carriers.[43]

Figure III-1 summarizes the dramatic shrinkage of the number of Class I railroads from over 30 to four dominant railroads.

Figure III-1: Rail Mergers Since the Passage of the Staggers Act



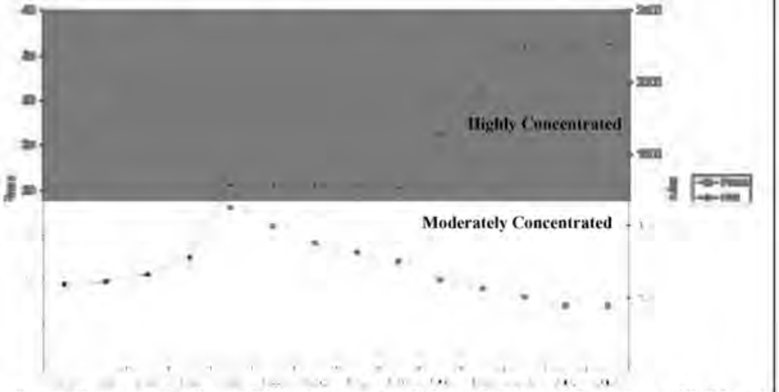
Source: "Testimony of David Cleavinger, President National Association of Wheat Growers, *House Committee on Small Business, Hearing to Review Rail Competition and Service,* May 1, 2008, p. 2.

The timing of the mergers and their impact on market structure is even more revealing, as shown in Figures III-2 and III-3. In spite of the fact that the rail services are a local or regional market, which is more concentrated than the national market, the national figures tell an interesting story. The early post-Staggers Act mergers moved the national industry from the competitive range – an HHI below 1000 and a four-firm concentration ratio of around 40 percent – into the concentrated range. There ensued a period of stable market concentration.

---

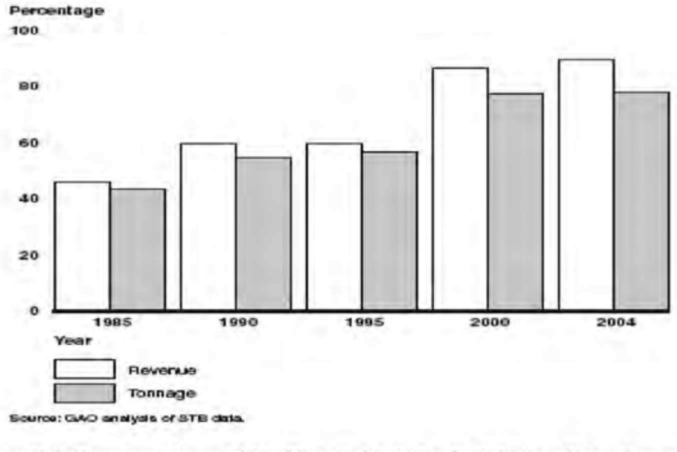
[43] Consumer Federation of America 1985b: 9, "Mergers have eliminated much rail-to-rail competition. Traditional measures of concentration, such as the four-firm concentration ratio or Herfindahl indices indicate large increases in concentration since mid-1980…. The cancellation of joint rates and reciprocal switching agreements – the traditional arrangements by which freight moves between rail systems – has shut down many inter-rail movements, rendering many more shippers captive to a single railroad. Mergers and cancellation of interline movements go hand in hand. (Cooper, Mark. 1987. *Bulk Commodities and the Railroads After the Staggers Act: Freight Rates, Operating Costs and Market Power*. Washington, D.C.: Coalition for Rail Fairness and Competition. October, p. 25).

Figure III-2: The Increase of Concentration Since the Staggers Act Measured by the HHI



Source: Transportation Research Board, *Research to Enhance Rail Network Performance* (Washington, D.C.: 2007), p. 68.

Figure III-3: The Increase of Concentration Since the Staggers Act Measured by the Four Firm Concentration Ratio



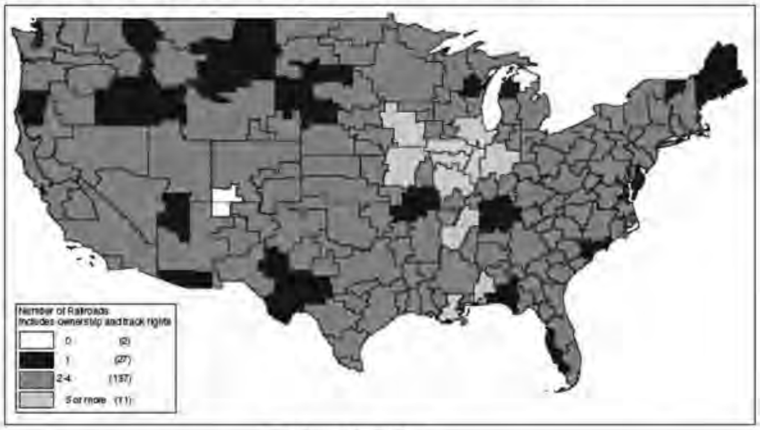
Source: GAO analysis of STB data.

Source: U. S. Government Accountability Office, *Freight Railroads: Preliminary Observations on Rates, Competition, and Capacity Issues,* June 21, 2006, p. 12

The mega-mergers of the 1990s set the foundation for the current round of complaints from shippers. There was a huge jump in concentration – a 1000-point increase in the HHI to 2200 and a 30-percentage point jump in the four-firm concentration ratio to 90 percent. Even at the national level, the railroad industry was well above the highly concentrated level. While the national level is relevant for identifying the pool of firms that are likely to enter local markets, the local market is the proper unit of analysis.

At the local level the market structure is of much greater concern, as shown in Figure III-4. The GAO recently did a study using the Bureau of Economic Analysis Economic Areas as the unit of analysis to assess the state of competition. While we believe that this overestimates the extent of competition because many of the economic areas are so large that the railroads identified in each area may be too far apart to provide effective competition for many shippers, clearly this is a more appropriate unit of analysis than the national level. With this unit of analysis, only 6 percent of the Economic Areas have five or more shippers. Thus, 94 percent of the Economic Areas were tight oligopolies. Fifteen percent of the areas had only one railroad. Over three-quarters of the markets defined as BEA areas had 2 or fewer railroads. They are very tight oligopolies. Unfortunately, the GAO did not disaggregate the 2-4 category. This is important because the literature finds a big difference in terms of market power between 2 and 4 railroads serving an area. To say that the rail industry is highly concentrated is an understatement.

Figure III-4: Number of Class I Railroads Service Economic Areas



Source: GAO analysis of BEA and GIS data.

Source: U. S. Government Accountability Office, *Freight Railroads: Preliminary Observations on Rates, Competition, and Capacity Issues*, June 21, 2006, p. 14.

MERGER, PRODUCTIVITY AND MARKET POWER

Econometric studies of the impact of mergers and changes in competition in this early period support the general conclusion that market power is a concern.

> These author's results seem to indicate that there was a large reaction to the new deregulated environment, but once that was achieved, the productivity and cost improvements slowed down considerably.
>
> These studies of the effects of the Staggers Act on competition and rates in the rail industry reveal three cautionary warnings about the impact of deregulation on rates. First, the more recent evidence reveals a threat to the benefits of deregulation, as firms have consolidated their market power and experienced service problems. Second, the benefits of deregulation have not been equally shared among shippers. Those beholden to one railroad have typically experienced higher rates than shippers with competitive choices. Finally, if these and other rate studies rely on revenue per ton-mile without controlling for the characteristics of the shipments, then the resulting conclusions on price will be influenced by these other factors.[41]

While some studies find that mergers increased efficiency, the effect of mergers is small. In general, it is clear mergers were not essential to the productivity gains the industry made and the anticompetitive effects became apparent and may outweigh efficiency gains.

> The overall effect of mergers can be to reduce total efficiency if scale economies are the dominant effect in the merger. Mergers have not had any effect on the efficiency of shipping operations since deregulation; there has been a general improvement since deregulation in the efficiency at this stage of production, but firms which merged have not improved any more than firms which did not merge. …
>
> If mergers do not increase efficiency, why have there been so many mergers in the industry? Our results are consistent with earlier research suggesting that mergers may enhance market power, due to the presence of fewer, larger firms serving the market. These large firms then price above cost, increasing rail profits but causing deadweight loss.[a/] In particular, the result that scale efficiencies in track networks can be reduced by mergers producing larger than efficient firms is potentially troubling. Since track is a very expensive sunk asset, not transferable to other markets or other uses, it can act as an entry barrier that protects incumbents against entry and allows them to earn excess profits.[b/] We conclude that pending and future mergers should be closely scrutinized to make sure that claimed efficiency improvements from the merger generally do exist, are not offset by increases in scale beyond efficient

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[41] Tye, William B. and John Horn, "Transportation Mergers: The Case of the U.S. Railroads," in K.J. Burton and D.A. Henser (Eds.), *Handbook of Transport Strategy, Policy and Institutions* (Elsevier), p. 465.

> market sizes, and are not smaller than deadweight loss inefficiencies cause by increases in prices as a result of those mergers.
>
> a/ Pittman finds evidence of such deadweight loss in post-merger pricing in the case of the ATSF merger.
>
> b/ This finding is consistent with that of Friedlander et al. (1992) which shows substantial rises in profitability since deregulation. Schmidt (1999) discusses the sunk nature of track at greater length and gives some price-based evidence that market power is a problem in markets served by a small number of carriers.[45]

The observation on the importance of track as a barrier to entry and the role it plays in creating market power as a result of mergers underscores the importance of refusals to deal and the hostility to interline movements that have afflicted the rail industry. The spin-off of large quantities of track into short lines could well be an effort to reduce the inefficiencies of becoming too large, but the anticompetitive conditions placed on the new short lines erode competition and enable the merging roads to pocket the gains and not share them with consumers as would happen in competitive markets. In this sense, the mega-mergers of the mid 1990s clearly seem to have violated the primary structural condition for efficiency. The conduct of the railroads compounds the problem when they get too big and spin off short lines, but then undermine competition with contracts that foreclose markets.

STIFLING COMPETITION THROUGH FORECLOSURE

Creating small railroads might provide interline movements to competitors that could undermine the accumulation of market power that results from mergers and increasing size. The trunk lines were determined to prevent this competitive threat from materializing. They ensured the market power created by the mega mergers could be preserved by encumbering the transfer of the track to the more efficient short lines. The analysis of these encumbrances suggests that shippers are, on balance, not better off and likely worse off. Thus, railroad behaviors that prevent shippers from having competitive alternatives in an increasingly concentrated market become the focal point of attention.

A theory was offered to justify clearly anticompetitive conduct that foreclosed competition. The theory claims that the shipper is either better off being captive to one monopolist or that it makes no difference that an interline movement with a competitive link is foreclosed. The claim is that there is one monopoly rent that will be captured by whichever entity has market power. This theory has been challenged and disproven across a wide range of contexts, including the rail industry (Massa, 2001).

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[45] Chapin, Alison and Stephen Schmidt, "Do Mergers Improve Efficiency? Evidence from Deregulated Rail Freight," *Journal of transportation Economics and Policy,* 33 part 2, pp.158-159.

> A sample of agricultural railroad movements is used to compare rates on traffic between markets where there is, and is not, a potential for such pricing behavior. The results strongly support the hypothesis that vertical exclusion pricing exists and varies across commodities with effects ranging from 6 to 24 percent…
>
> In our model service differentials can provide a situation when railroads find it profitable to exclude upstream/downstream barge competition despite the fact that the railroad has higher operational costs. Further, the incentive to exclude barge is greater if the railroad operates with economies in production. Within the context of rail-barge competition, this strategy dictates that the railroad price over the rail-only leg of a potential intermodal routing will be higher than the optimal prices observed on similar non-intermodal routings. This is precisely what we observe in the pattern of railroad prices for the movement of grain. Consequently, we find evidence supporting the argument that vertical exclusion aimed at precluding barge participation in potential intermodal movements exists as a railroad pricing practice. Because this practice diminishes, or eliminates, the presence of one transportation mode in a variety of markets, the tendency may be regarded as anticompetitive.[46]

> It is clear that, to the extent interline competitors are eliminated by vertical integration (or tied sales), a welfare loss to shippers will result; if interline competition is promoted; there will be a welfare gain. The possibility of foreclosure arises in a number of related rail-policy issues: end-to-end mergers, route cancellations, and access to facilities.[47]

> There is little cooperation among mainline railroads to manage the rail network as an integrated system. Individual railroads manage their own networks to maximize their revenue; in so doing, they may ration capacity or allocate traffic for some kinds of freight over others, thereby degrading the whole system's performance, participants claimed.[48]

A clear refutation of the theory occurred when competition for coal hauling entered the Powder River basin. Theory would have predicted that as rates declined due to competition at the origin of movements in the Powder River Basin, monopoly railroads at the destination would have increased their rates to capture the one monopoly rent (the "one-lump" theory) that was available. Apparently, this did not happen. Utilities that were not captive to any railroad on the destination side experienced substantial rate reductions when competition occurred on the origin side, which is expected, but utilities that were captive on the destination side also enjoyed rate reductions, contrary to the theoretical prediction.

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[46] Burton and Wilson, "Network Pricing: Service Differentials, Scale Economics, and Vertical Exclusion in Railroad Markets," *Journal of Transport Economics and Policy,* 40: 2006, pp. 255, 275-176.

[47] Grimm, Curtis M., Clifford Winston, and Carol A. Evans, 1992, "Foreclosure of Railroad Markets: A Test of Chicago Leverage Theory,' *The Journal of Law and Economics,* 35(October), p. 305

[48] Ortiz, David, S., Brian Weatherford, Henry Willis, Myles Collins, Naveen Mandova, and Chris Ordwich. 2007. Santa Monica. Rand. p. 2

> But even many utilities whose plants could be served by only one carrier saw their coal transportation rates go down significantly, provided the delivery carrier was "neutral" (that is, not aligned with either BN or CNW/UP). Such shippers were still able to solicit bids from both BN and CNW/UP for the right to originate their traffic (such bids were in most cases submitted as part of alterative joint rates with the neutral delivery carrier). The resulting through bids were typically much lower than the joint rates such shippers had paid before CNW/UP's entry into the PRB.[a/]
>
> [a/]How and why such shippers seemed to benefit form the new origin competition, despite remaining captive at the destination, has been the subject of much debate… Notwithstanding the one-lump theory, however, many representative of destination-captive coal shipper testified to the savings they achieved when they began to play the origin carriers off against one another in competitive bidding. Seeking to explain this phenomenon, some experts have suggested that the answer may lie in the nuances of inter-carrier relations (for example, the destination carrier might wish to remain on good terms with both origin competitors, and therefore not wish to be seen as too greedy or favoring one over the other, leading it to give each origin carrier the same "revenue requirement" for its delivery service, which in turn would allow the competing carriers' price cuts to pass through to the shipper).[49]

The key observation in this example is that the overall competitive fabric of the industry is extremely important. As long as there is a complex set of multimarket contacts between competing lines, they may not find it in their interest to extract the rents in individual origin cases, for fear of triggering retaliation in many other cases. This is particularly important for short lines, which are dependent on trunk lines for the origination of traffic. This observation underscores the threat of a highly consolidated industry that is also insulated regionally. As two railroads each come to dominate separate regions of the nation, the competitive market structure is simplified, making the anticompetitive extraction of rents easier.

The dramatic foreclosure of competition on short lines, many of which were created through spin-offs from mergers, becomes a particularly important competitive issue. The creation of paper barriers – contract conditions that preclude competition through interline movements involving the short lines – is the quintessential "artificial inhibition on entry." If efficiency gains can be achieved by breaking up the one monopoly, which appears to be the motivation for the spin off of short lines, then cost declines may result in quality improvement or rate reductions. Encumbering short line segments that link to potentially competitive interconnection points with anticompetitive conditions can have negative long-term effects, keeping rivals out of the market, increasing costs if there are diseconomies of scale, and preventing or distorting the location of new facilities. In the case of short lines in the U.S. these negative outcomes are distinct possibilities. There are significant amounts of track involved (almost one-third of total U.S. plant), large quantities of traffic are exchanged with trunk lines (as much as two thirds of short line traffic), and significant price increases resulting from the anticompetitive practices that competitive interline movements could address.

---

[49] Avery and Ericson, 2004, p. 6

> The exact magnitude of the competitive benefits from removing paper barriers is difficult to quantify, but the circumstantial evidence suggests that the benefits may be significant. As this article has noted, many regional and short lines are restricted in their ability to interchange traffic with another carrier. Moreover, a large volume of regional and short line traffic is interchanged with another carrier. A recent survey of 170 regional and short line railroads shows that 66 percent of the survey respondents' traffic is interlined with another carrier. According to the former president of a regional and short line trade group, trunk lines earn 4 billion of revenues from interchanging cars with regional and short line annually. He also claimed that shippers may pay as much 25 percent more for rail service because of paper barriers.[50]
>
> "Paper barriers" are additional short-line railroad problem vis-à-vis Class I railroads. These result when the selling Class I railroad, as a condition of sale, insists that the purchasing carrier will only interline with the selling railroad, even if other short-lines of Class I carriers have trackage that connects to the purchasing short-line. The result is that the acquiring railroad has much less bargaining power with the Class I carrier, because it can only use one railroad to interline traffic.[51]
>
> Yet another Class I related problem is that the large railroads sometimes try to convince shippers to establish their new facilities directly on the Class I's trackage, as opposed to locating on the short-line carriers trackage. Another conundrum for short-line carriers is when Class I railroads try to persuade shippers to truck their freight directly to the Class I's trackage. This is done so the railroad will not have to split the rail revenue with the short-line carriers.[52]

Given that the various behaviors to foreclose competition conflicted with the stated purpose of the Staggers Act to promote competition and the evidence that this conduct has undermined competition and harmed shippers, it is not surprising to find that these issues have received a great deal of attention throughout the post-Staggers period. A variety of actions by the railroads to foreclose competition have been identified by shippers;[53] but the STB has failed to take action to stop their practices. The list is long. The GAO identified four major areas shipper demanded action to counter the anticompetitive conduct of the railroads.

---

[50] Massa, Salvatore, "A Tale of Two Monopolies: Why Removing Paper Barriers is a Good Idea," (2001) *Transportation Journal,* Winter Spring, p. 55

[51] Johnson, James C., Diane J. McClure, Kenneth C. Schneider and Donald F. Wood. 2004. "Short-line Railroad Managers Discuss Their Industry." *Transportation.* 31, p. 101

[52] Johnson, et al. 2004: 101

[53] House Judiciary Committee Antitrust Task Force on Antitrust and Competition Policy, *Hearing on H.R. 1650 The Railroad Antitrust Enforcement Act of 2007,* February 25, 2008; GAO, October 2008.

> *Reciprocal switching:* This approach would allow STB to require railroads serving shippers that are close to another railroad to transport cars of a competing railroad for a fee. The shippers would then have access to railroads that do not reach their facilities...
>
> *Terminal agreements:* This approach would require one railroad to grant access to its terminal facilities or tracks to another railroad, enabling both railroads to interchange traffic or gain access to traffic coming from shippers off the other railroad's lines for a fee...
>
> *Trackage rights:* This approach would require one railroad to grant access to its tracks to another railroad, enabling railroads to interchange traffic beyond terminal facilities for a fee...
>
> *"Bottleneck" rates:* This approach would require a railroad to establish a rate, and thereby offer to provide service, for any two points on the railroad's system where traffic originates, terminates, or can be interchanged. Some shippers have more than one railroad that serves them at their origin and/or destination points, but have at least one portion of a rail movement for which no alternative rail route is available. This portion is referred to as the "bottleneck segment"...
>
> *Paper barriers:* This approach would prevent or put a time limit on paper barriers, which are contractual agreements that can occur when a Class I railroad either sells or leases long term some of its track to other railroads (typically a short-line railroad and/or regional railroad). These agreements stipulate that virtually all traffic that originates on that line must interchange with the Class I railroad that originally leased the tracks or pay a penalty.[54]

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[54] GAO, Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should be Addressed, October 2006, pp. 44-50.

IV. MARKET CONDITIONS AND MARKET POWER

Market power gives the railroads the ability to increase prices, but other factors affect the opportunity to exercise it. The exercise of market power is an effort to charge whatever the market will bear. What the market can bear reflects conditions on both the supply-side and the demand side. On the supply-side the question is "if prices are increased can competitors increase their output while charging lower prices, to steal customers?" On the demand side the question is, "what alternatives do consumers have that can substitute for the product whose price is being increased?"

The economic environment of the past half-decade or so has raised the ability of the railroads to increase prices. In addition to concentration that has reduced head-to-head rail competition and anticompetitive practices that have further dampened the competitiveness of the sector, there are several key economic conditions that have enabled the railroads to intensify their abuse of market power.

INADEQUATE CAPACITY

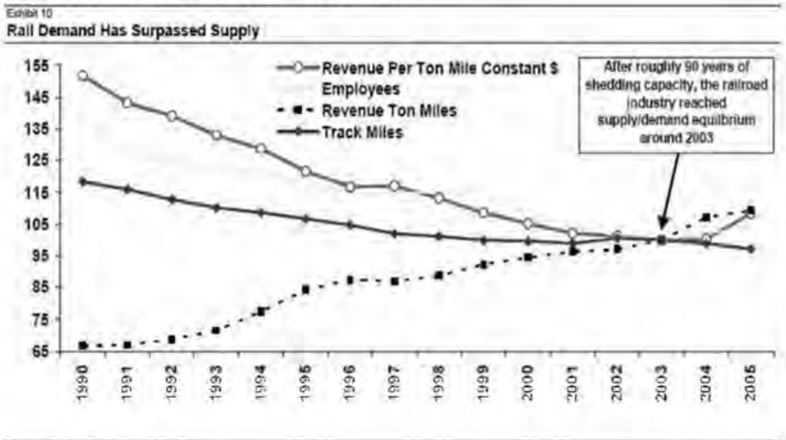
Inadequate capacity has diminished the incentive and ability for railroads to compete on price. The impact of capacity shortages in an oligopoly market structure raises concerns because it increases the likely abuse of market power. Lacking spare capacity, railroads do not feel pressures to lower prices in order to increase traffic. Not facing vigorous competition, they do not feel threatened by others increasing capacity or pressure to increase their own capacity.

> In a truly competitive market, competition ultimately would decrease rates over time as additional capacity enters the marketplace either from existing or new railroads.
>
> Therefore, one might contend that currently high rail rates simply reflect the competitive marketplace at work. When demand increases, prices rise in order to efficiently distribute existing capacity and to encourage the addition of new capacity…
>
> But if the market is not truly competitive, this constant gravitation towards equilibrium does not occur. Supply remains artificially constrained, which keeps prices artificially high. This is an alternative explanation for what is occurring in the rail industry today.
>
> After a century of operating with excess capacity, the rail industry finally appears to have exhausted much of its capacity through a combination of abandonments, mergers and growing demand. There appears to be little incentive, however, for existing railroads to increase their own capacity levels needed to satisfy demand for rail service, and it is highly improbable that new

> railroads could enter the market with sufficient new capacity due to substantial barriers to entry.
>
> A series of rail merger over the past 25 years has created a highly concentrated industry, resulting in rail duopolies in the eastern and western halves of the country. Even in markets that continue to be served by two railroads, there is little incentive to compete for business that the other is unable or unwilling to handle, when both railroads have tight capacity constraints.
>
> This capacity shortage has provided railroads with unprecedented pricing leverage over their customers. As duopolists, it is easy for the railroads to maintain this leverage by adding capacity only at the margins, rather than to meet total demand. This is consistent with rational monopoly behavior that increases prices by keeping capacity below competitive market levels, resulting an inefficient marketplace. As a consequence, supply shortages, in the form of capacity constraints, become endemic and rates remain perpetually higher than they would be in a truly competitive market. (Ficker, 2006, 290-291).

As Morgan Stanley sees it, supply equaled demand in 2003 in terms of track and revenue ton miles (see Figure IV-1). By 2005, demand exceeded supply in the Morgan Stanley analysis. Since then the trend has continued. Since 2003, there has also been a sustained increase in rates.

Figure IV-1: Rail Demand Exceeds Supply

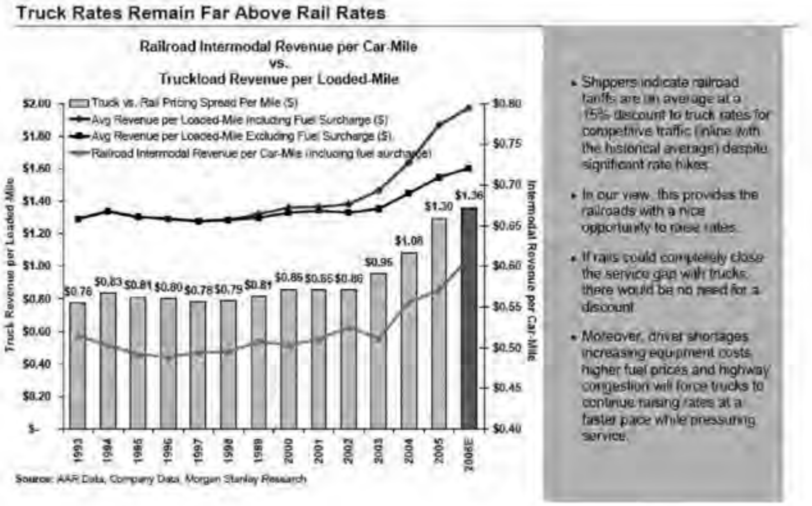


Source: Morgan Stanley, *Transportation: Initiation of Coverage: Rails Have More Room to Run on Pricing,* May 7, 2007, p. 6.

ENERGY PRICES

Rising energy prices have expanded the opportunity for railroads to increase prices on both the supply-side and the demand side. On the supply side, rising fuel prices hurt trucks much more than railroads (see Figure IV-2). This enables the rails to increase prices and still not lose traffic to trucks.

Figure IV-2: Truck v. Rail rates



Truck Rates Remain Far Above Rail Rates

Source: AAR Data, Company Data, Morgan Stanley Research

- Shippers indicate railroad tariffs are on average at a 15% discount to truck rates for competitive traffic (inline with the historical average) despite significant rate hikes.
- In our view, this provides the railroads with a nice opportunity to raise rates.
- If rails could completely close the service gap with trucks, there would be no need for a discount.
- Moreover, driver shortages increasing equipment costs, higher fuel prices and highway congestion will force trucks to continue raising rates at a faster pace while pressuring service.

Source: Morgan Stanley, *Transportation: Initiation of Coverage: Rails Have More Room to Run on Pricing,* May 7, 2007, slides, p. 9.

As Morgan Stanley put it:

> **Beyond re-pricing, we believe rail rates remain far below those of competing trucking.** Truckload (TL) carriers continue to face significant cost pressures from driver turnover, rising fuel prices, new engine purchase requirements, and highway congestions. None of these cost pressures appear to be abating. As such, we believe TL carrier will continue to push, when possible, on rates. This should give rails ample opportunity to raise prices on truck-competitive business (which we estimate is only 20-30% of the volume), as average rail intermodal rates remain 65% below average truck rates on a

> per-loaded-mile basis and 15% per load in comparable lanes. Moreover, rail shipping is roughly five times more fuel-efficient than truckload on a ton-mile basis. If fuel prices continue rising, the impact of fuel surcharges from trucks should make rail an even more competition option for shipper.[55]

On the demand side, rising energy prices increase the cost of alternative fuels, fuels not delivered by rail, to utilities. The railroads have more headroom to extract higher prices. Because the trucking industry and the coal industry are more competitive than the rail industry, they have less ability to capture the rents. They would compete the prices down and consumers would not have had to pay them. When the rail industry uses its market power to capture the rents, it imposes an additional burden on the public that, absent the exercises of rail market power, the public would not be force to bear.

> At the same time, higher natural gas prices increased demand for utility coal, giving us higher volumes and more pricing power. In general merchandise as well, higher demand for our transportation services, along with our continuing efforts to improve service, have provided growth opportunities.
>
> It is a good time to be in the railroad business, as revenues reflect. The financial markets also have noticed, with rails considerably outperforming the Standard & Poor's averages. Obviously, the state of the industry is robust, and we have every reason to be optimistic about the future. At the same time, we continue to face challenges, some driven by our own success. They include capacity constraints, the need to improve service reliability and consistency, the threat of re-regulation, and the handling of highly hazardous materials. [56]

Figure IV-3 shows monthly refiner acquisition costs of crude oil over the period from 1974 to 2008. We take the natural log of the price to show the rate of growth of oil prices. Just prior to the passage of the Staggers Act prices spiked giving railroads their first opportunity to capture rents from coal by increasing prices. In the half-decade since 2002 we again see a dramatic increase in energy prices. The availability of rents triggers price increases on captive traffic.

The rail industry has also come to benefit from being insulated from the business cycle.

> Railroads will be less impacted by economic trends than other freight transportation companies (parcel and trucking). Recall that roughly one-third of the railroads' volumes are commodities with low GDP sensitivity, such as

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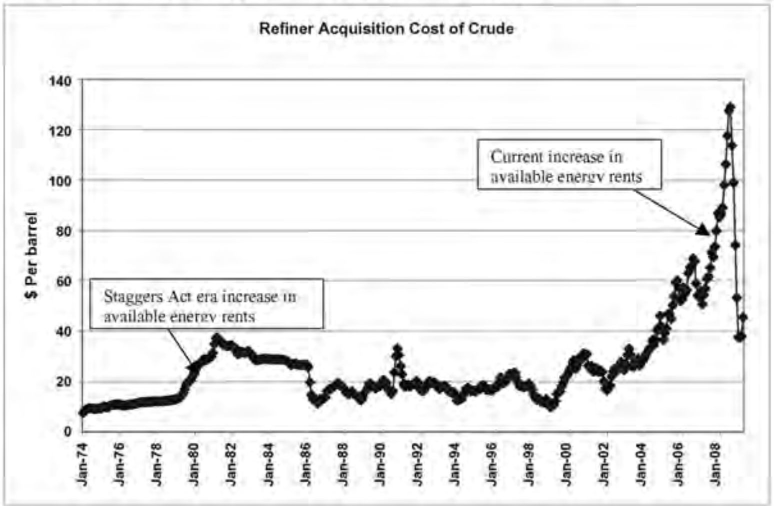
[55] Morgan Stanley, 2007 p. 7.

[56] Moorman, Charles E. 2007. Freight Rail Perspective on Capacity Issues. *Research to Enhance Performance.* Washington, D.C.: Transportation Research Board, p. 38

> grain and coal. As such we believe railroads can be a good defensive play into a downturn, while offering growth outside of the economic cycle.[57]

Figure IV-3: Rising Energy Prices Trigger Rent Seeks by Railroads



Current increase in available energy rents

Staggers Act era increase in available energy rents

Source: Energy Information Administration, *Refiner Acquisition Costs*, Petroleum Prices database.

THE DECLINE OF COMPETITIVE RIVALRY

Market power, tight capacity, available rents, and insulation from the business cycle combine to change the fundamental competitive behavior in the industry. A tight oligopoly at the national level, a duopoly in the two major regions in the country and a monopoly in many markets at the local level makes it more likely that the recognition of mutual interest in avoiding competition will prevail in price setting. With duopolies in the east and west, the rails learn how to reduce competitive rivalry.

> Evidence was also found that once deregulation occurred, market-share instability began to decrease exponentially, suggesting that railroads were learning to avoid competition in the new regulatory environment. While this

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[57] Morgan Stanley, 2007, p. 4.

interpretation is supported by the regression results, another interpretation is possible. It is possible that the increase in market share instability following deregulation may not be an event distinct from the process of learning how to avoid competition. The post-deregulation increase in instability may, in fact, be part of an adjustment process that brings about more stability.

But regardless of which interpretation is correct, the regression results suggest that as experience with deregulation grows, competition in the railroad industry will again approach levels experienced prior to deregulation and that examples of competitive performance in the early years of deregulation will become less and less frequent. If this suggestion is correct and can be generalized, the further implication is that when industry structure approximates classic oligopoly, as the railroad industry does, a procompetitive government policy does not imply absence of a role for government but, instead, increases the responsibility of government to enforce vigorously antitrust policy, that collection of statutes, administrative law, and judicial ruling developed to insure competition in industries not subject to economic regulation.[58]

Wall Street sees the current economic circumstances as inviting for such behavior.

[O]ur analysis of railroad revenue and contracts, combined with our shipper survey (to be published later this week), gives us confidence that pricing well above inflation is sustainable through 2010. In addition, we believe that a new generation of post-deregulation management may avoid the competitive excesses that pressured railroads pricing in the past.[59]

Mgmt. affirmed that it will not sacrifice price to get back vol. And suggested that the sweet spot for UNP was perhaps with even fewer vols. Still, pricing remains firm and UNP has the biggest opportunity among the rails to reprice its legacy contracts. We believe UNP also has significant productivity/margin upside from reducing re-crew costs, increasing train lengths and managing corporate expense.

In addition, management made it clear that some of the softness in rail volumes is clearly market share losses as the rails focus more on margins and returns are willing to price some business off the rails that probably never belonged on the rails to begin with (i.e. some short-haul intermodal and rocks business as examples). This issue has been compounded in the near term by excess truck capacity and negative y-o-y trucking rates. Management also made it clear that over the next few years investors should be prepared for the

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[58] Fitzsimmons. Edward. and James Knudson. 1991. Market Share Instability among Class I Railroads and the Impact of Deregulation. *Quarterly Review of Economics and Business*. 32:2. Summer.

[59] Morgan Stanley, 2007, p. 5.

> possibility that UNP walks away from some large contracts that are set to re-price, if they cannot agree upon an acceptable return.
>
> The focus will be on pricing and margins, which we believe should drive UNP beyond its mid-70's operating ratio target by 2010.[50]

Phrases like "avoiding competitive excess," "not sacrifice price to get back vol." are euphemisms for the existence of market power.

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[50] Bear Sterns, *Union Pacific,* September 10, 2007, pp. 1, 2, 4.

PART III: PERFORMANCE:

THE ABUSE OF MARKET POWER IN THE RAIL INDUSTRY

V. THE IMPACT OF MARKET STRUCTURE: PRICES

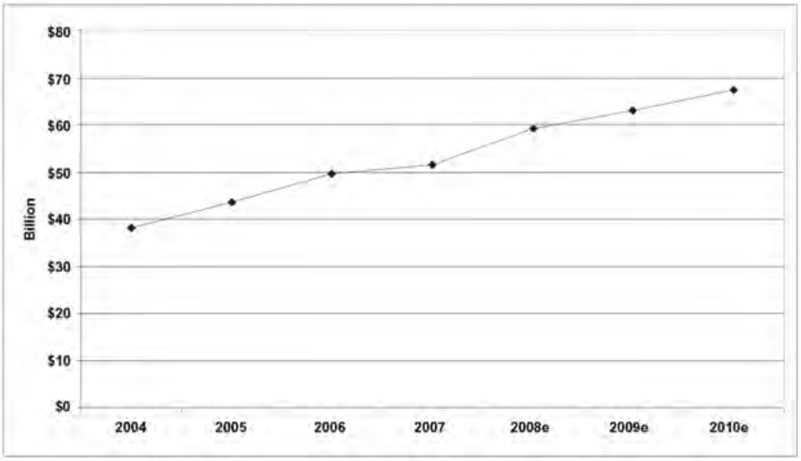
NATIONAL RATE INCREASES

After the mega-mergers were completed, a significant period of service disruptions occurred that occupied the attention of the rails, shippers and regulators. When the service problems moderated, rates for the most captive traffic began to rise. When rail capacity became tight and energy price rose, the increase in price accelerated.

At the national level this can been seen in the uptick in the amount of freight that was charged over 300 percent of variable cost, but the data compiled by the GAO ends where the largest price increases were just beginning.[illegible] Unfortunately, the most recent publicly data available from the STB only extends to 2005. While it suggests a sharp increase in rates for captive traffic, it too misses the large run up in prices in recent years (Surface Transportation Board, *Commodity Revenue Stratification Report* various years)

For more recent years we must turn to private sector sources. Annual reports from the railroads and Wall Street projections indicate rapidly rising revenues. As shown in Figure V-1, revenues are growing rapidly.

Figure V-1: Revenue of the Four Major Freight Railroads (BNSF, CSX, NS, UP)



Source: Actual 2004-2007, Annual Reports; Estimated 2008-2010, Goldman Sachs, *Americas: Transportation: Railroads*, September 23, 2008

[illegible] GAO *Freight Railroads, Preliminary Observations on Rates, Competition and Capacity Issues*, June 21, 2006, p. 16.

Although revenues are not a perfect indicator of rates, we do know that over the period covered in Figure V-1 volume growth has been sluggish.[62] Clearly, a large part of the increase in revenues has come from rate increases. There is little wonder that Wall Street is bullish on rail pricing power.

> To review the background, In the 20+ years after deregulation, railroads shed unprofitable lines, reduced capacity, eliminated excess headcount and consolidated from 39 large railroads to 7 today. These decade-long changes brought rail capacity in line with demand for rail transportation by roughly 2003-04, such that pricing reversed its seemingly endless downward march. At first, the industry took slight increases in rates on certain merchandise traffic as capacity began to limit the railroads' ability to grow volume. As these yield initiatives succeeded, the railroads began the process of re-pricing their oldest legacy contracts, which were established well before 2004 when rails needed volume. With their networks now full, rails began to move the legacy contracts up to market and price on a fully-allocated basis (i.e. including the cost of capital). *In some case, this resulted in rate increases of 30%+ for shippers...*
>
> **Repricing of legacy contracts isn't finished.** Based on our latest rail shipper survey, we estimate that 20% of the business on the rails today is still moving under legacy contracts that have yet to be re-priced. Specifically, international intermodal and utility coal still have a number of long-term contracts below market (especially at the Western railroads). Although days of 6-8%+ pricing on a quarterly basis may be behind the rails, we see rail pricing continuing to rise 3.5%-6% (depending on the company) for at least the next 3 years. In fact, a number of railroads claim they did not find the point of price elasticity during the first round of renewals, which implies there may be further rate hikes as these contracts come up for renewal a second time.[63]

Morgan Stanley projects double digit increases in legacy contract (as shown in Figure V-2).

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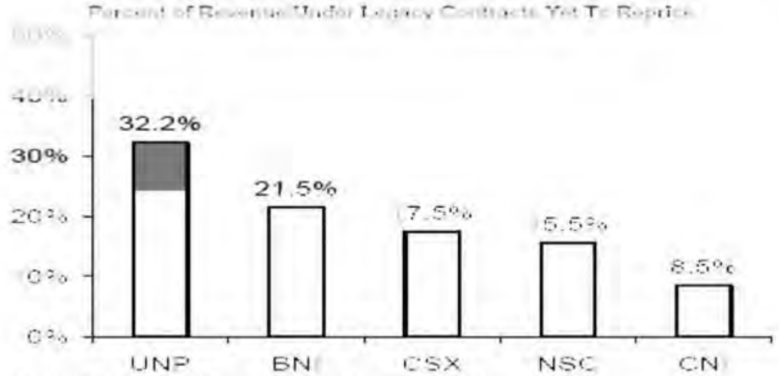
[62] Morgan Stanley, 2007, p. 14.
[63] Morgan Stanley, 2007: 5.

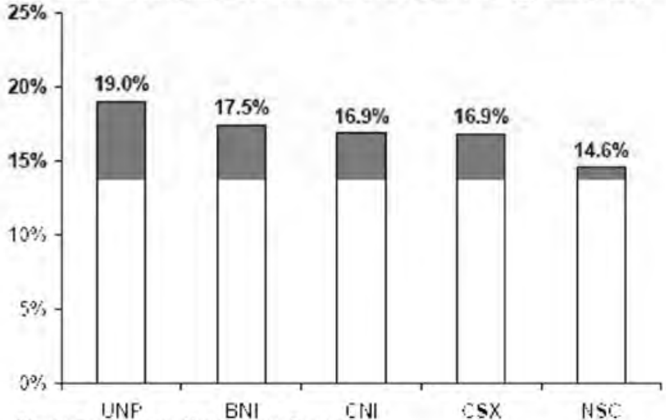
Figure V- 2: Pricing Power and Revenue Growth

Still a Fair Amount of Legacy Contract Repricing to Go



Source: Morgan Stanley Research estimates as of 2006 year-end

Cumulative Railroad Revenue Growth from Pricing, 2007E-2010E



Source: Company Data, Morgan Stanley Research

Source: Morgan Stanley, *Transportation: Initiation of Coverage: Rails Have More Room to Run on Pricing,* May 7, 2007, Slides, pp. 6-10.

In spite of the looming recession, Wall Street remains bullish on the rails for the three reasons identified in the last section.

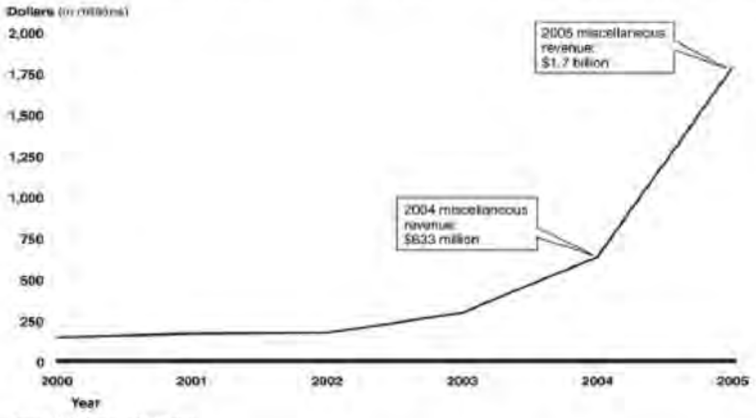
The long-term outlook for US railroads remains very favorable due to continued pricing power, relatively steady end-market conditions, and a competitive fuel efficiency advantage over other forms of commercial transportation.[64]

SURCHARGES

The rates discussed above do not include fuel surcharges and other add-ons that have skyrocketed in recent years. As Figure V-3 shows, these surcharges increase eightfold between 2002 and 2005 and they have continued to mount since then.

Figure V-3: Miscellaneous Revenues

Figure 4: Miscellaneous Revenue Tracked in Carload Waybill Sample, 2000-2005



Source: GAO analysis of STB data.

Source: U.S. Government Accountability Office, *Freight Railroads: Updated Information on Rates and Competition Issues*, September 25, 2007, p. 11.

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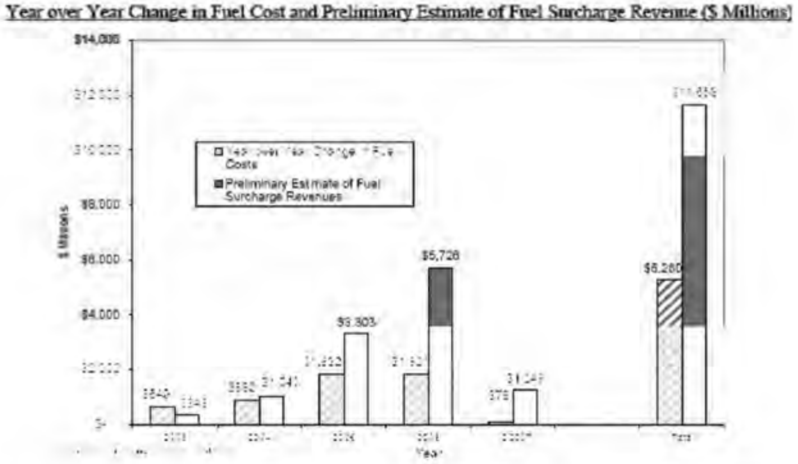
[64] Goldman Sachs, *Americas: Transportation: Railroads*, September 23, 2008, p. 1

Fuel surcharges, in particular, have become a major source of price increases for the rails and are likely to remain so, as Morgan Stanley put it "**we believe more of the future pricing upside will come from rate escalators embedded in new contracts that ensure the rails will see price increase every year** across most of the portfolio."[88] A study for the American Chemistry Council argues that between 2004 and 2007 more than half of the fuel surcharges collected were actually an over-recovery (see Exhibits V-4).

Figure V-4: The Growing Importance of Fuel Surcharges as a Rail Profit Center



Source: Snavely, King, Majoros O'Connor & Lee, *Analysis of Rail Fuel Surcharges During the Period 2003-2007*, Washington, D.C.: July 25, p. 9.

More recent data for the beginning of 2008 indicates that the trend has continued. Excessive fuel surcharges have become a major component of the rising cost of rail service, as shown in Figure V-5.

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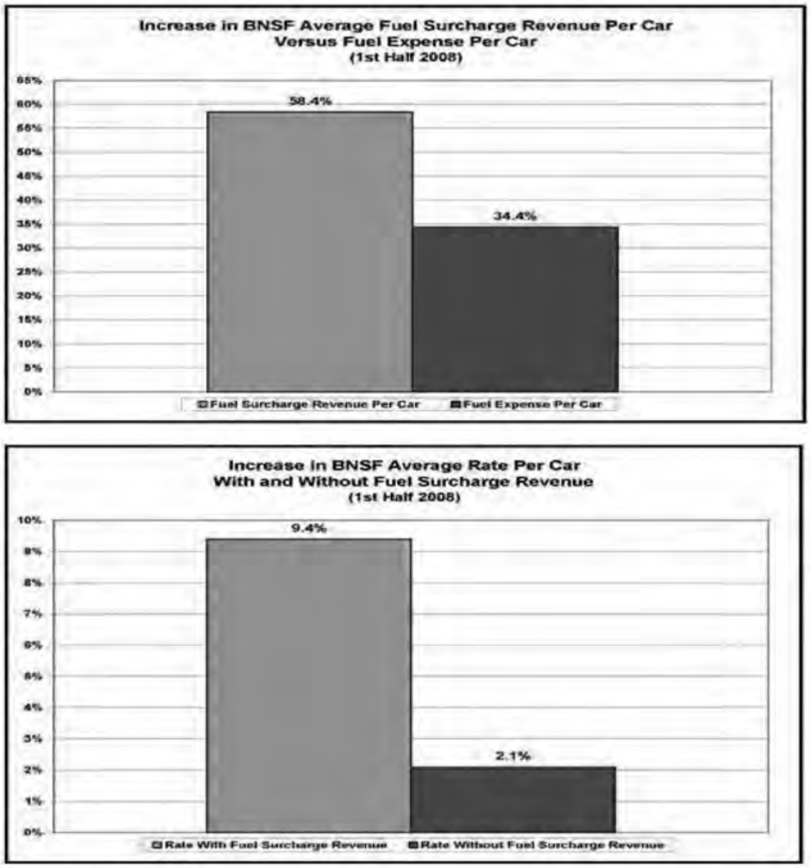
[88] Morgan Stanley 2007 p. 6.

Figure V-5: Fuel Surcharges Become a Profit Center



Source: Escalation Consultants.

VI. THE IMPORTANCE OF COMPETITION: PRICE INCREASES IN LOCAL MARKETS FOR SPECIFIC COMMODITIES

In the discussion of market structure we showed that the national figures obscure much larger problems because rail markets are local or regional and different products have very different characteristics, making product markets very distinct. The local product and geographic markets are more concentrated than the national market. Therefore, we would expect that the pricing impacts of market structure are more pronounced in specific product and geographic markets.

GEOGRAPHIC AND PRODUCT MARKETS

We can begin with the GAO analysis that looked at the overlap of local market structures and the amount of traffic moving at rates above the captive threshold of an RVC ratio of 180 percent. The GAO focused primarily on the monopoly situations, rather than the broader issue of lack of competition and found that:

> Our analysis shows that some areas of the country with access to only one Class I railroad have higher levels of traffic traveling at rates over the statutory threshold for rate relief. This situation may reflect reasonable economic practices by railroads in an environment of excess demand, or it may represent the abuse of market power.… When combined with comments from participants and our expert panel and interviews with shipper and railroad groups, the results of our analysis suggest that shippers in selected markets may be paying excessive rates, meriting further inquiry and analysis.[56]

The suggestion that either a capacity shortfall (excess demand) or abuse of market power may be the cause of the problem points to a market structural problem in both cases. The lack of competition has allowed to the rail industry to shrink capacity to the oint where it can exercise market power. There are other observations that can be offered by expanding the consideration of market structure.[57]

- Those areas served by five or more railroads tend to have lower rates.
- Those areas served by one Class I railroad that are close to water tend also to have lower rates. In other words, the lack of competition results in higher prices.

This conclusion is reaffirmed when we examine the difference between rates paid for commodities that are shipped under different competitive circumstances. Figure VI-1 compares the rates paid for captive and non-captive shipments of specific classes of commodities on the four major freight railroads.

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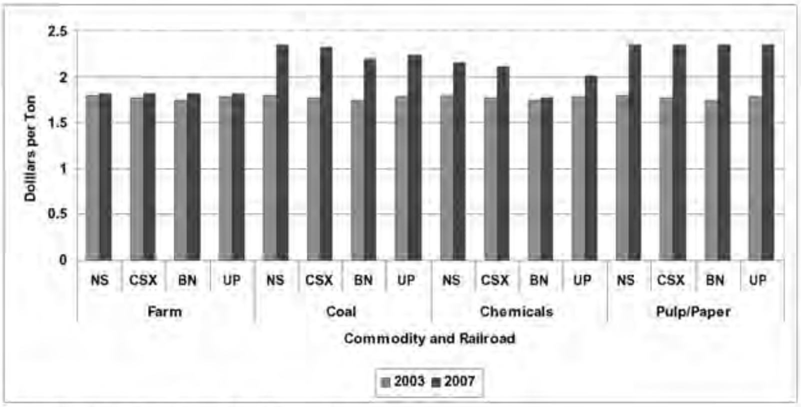
[56] GAO, October, 2006, pp. 37-38.
[57] GAO October 2006, pp. 14, 37.

The ratio of captive to competitive rates for four commodities that are frequently captive are shown for 2003 and 2007. There are two important points.

- First, in 2003 captive traffic was charged about 75 percent more than competitive traffic.
- Second, for three of the four commodities captive traffic rates increased much more than competitive rates by 2007. The tightening of capacity and rising energy prices combined with rail market power to increase rates on captive commodities.

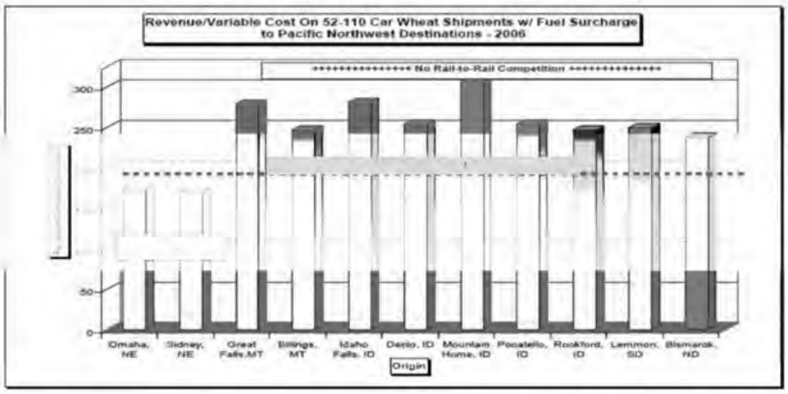
Figure VI-1: Cost of Captivity 2003:2007: Ratio of Captive Rate to Non-competitive Rates



Source: Escalation Consultants, Waybill Sample.

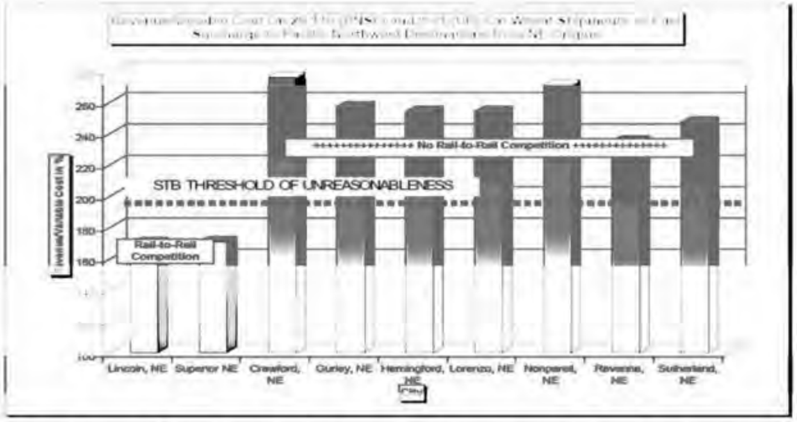
Having observed the impact of captivity separately in geographic and product markets separately, when we examine specific product and geographic markets we find very large differences in matched comparisons of movements of specific commodities on specific routes (See Figures VI-2, VI-3, and VI-4). Captive shippers pay a heavy premium. The most striking effects can be seen in rates on routes for captive commodities that lost competition during the wave of mega-mergers. On the four routes shown, mergers eliminated competition in the mid-1990s. The share of traffic where rates exceed 300 percent of variable costs skyrocketed after the mega-mergers of the 1990s, affirming the earlier findings.

Figure VI-2: RVC Ratios for Pacific Northwest Wheat Shipments



Source: "Testimony of Wayne Hurst, National Association of Wheat Growers," ***House Committee on Transportation and Infrastructure, Hearing to Review Rail Competition and Service,*** **September 25, 2007, p. 8.**

Figure VI-3: RVC Wheat Shipments Nebraska – Pacific Northwest



Source: "Testimony of Wayne Hurst, National Association of Wheat Growers," ***House Committee on Transportation and Infrastructure, Hearing to Review Rail Competition and Service,*** **September 25, 2007, p 12.**

Figure VI-4: Upper Midwest Grain Shipments

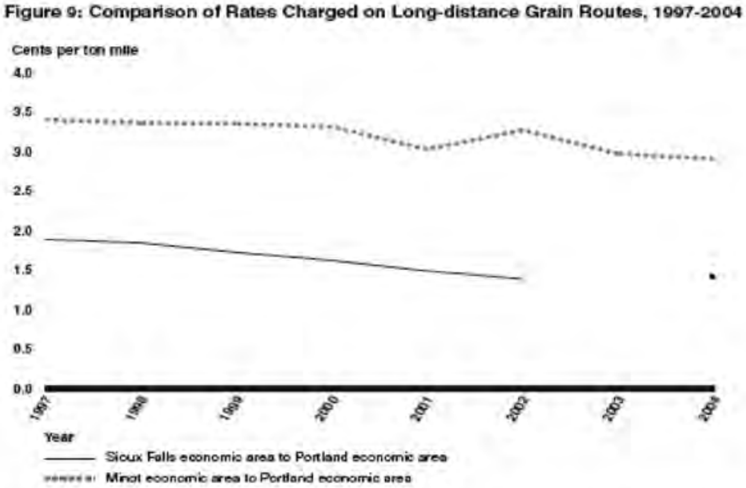


Figure 9: Comparison of Rates Charged on Long-distance Grain Routes, 1997-2004

Source: U.S. Government Accountability Office, *Freight Railroads: Industry Health Has Improved, But Concerns about Competition and Capacity Should be Addressed*, October 2006, pp. 24.

As shown in Figure VI-5 Prior to the mega-merger there was little, if any traffic that moves at an R/VC of 300 percent. After the mergers, almost half moved at that level. In an industry where an average R/VC ratio of 130 to 150 percent is what is needed to achieve revenue adequacy, rates at 300 percent are excessive.

Figure VI-5: Post Merger Rate Increases on Individual Routes

Figure 8: Percent of Tonnage Traveling Over 300 Percent R/VC, 1985-2004

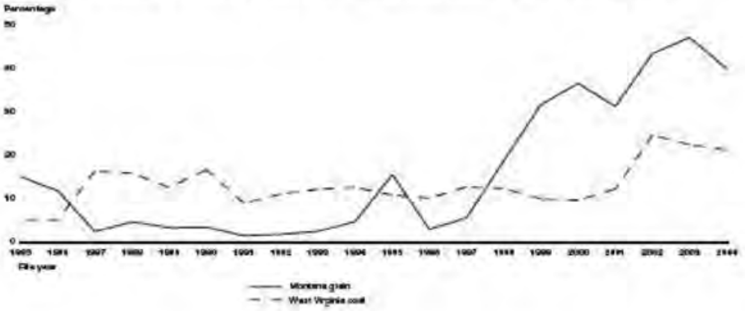
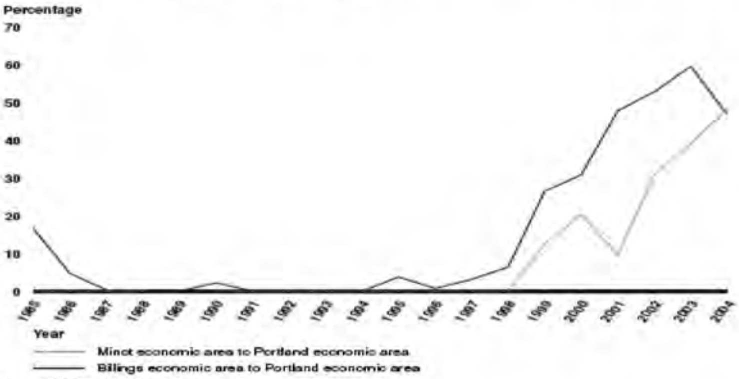


Figure 19: Long-distance Grain Route Changes in Percentage of Tonnage Traveling at Rates over 300 Percent R/VC, 1985-2004



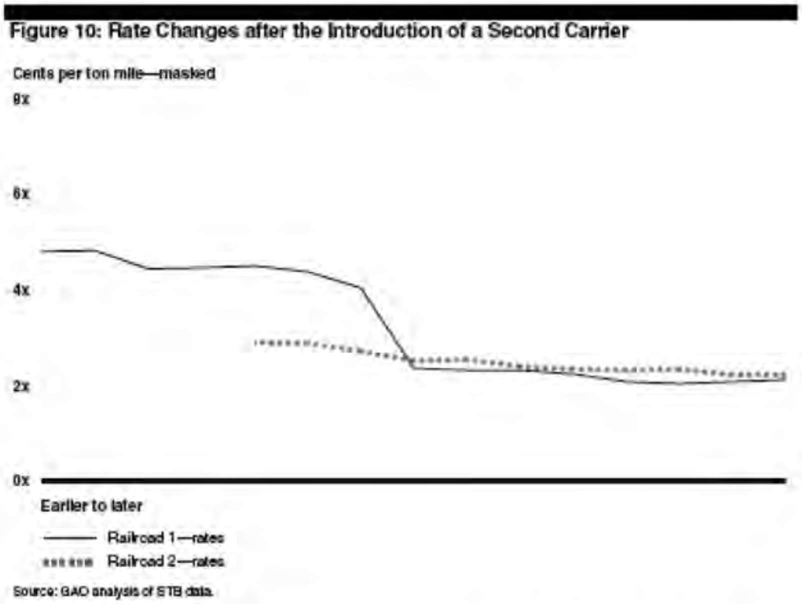
Source: GAO analysis of STB data

Source: U.S. Government Accountability Office, *Freight Railroads: Industry Health Has Improved, But Concerns about Competition and Capacity Should be Addressed,* October 2006, pp. 18, 23.

THE IMPORTANCE OF COMPETITION

The previous discussion highlights the importance of competition in ensuring reasonable rates by highlighting the exit of a competitor from the market. We observe a similar effect with entry of a rail competitor. As Figure VI-6 shows, rates fell by 50 percent in one of the rare instances where there was new entry of competition.

Figure VI-6: Entry of Competitive Rail

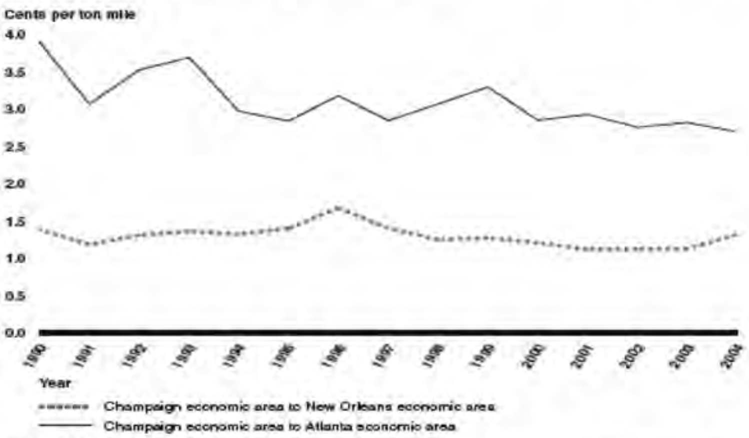


Source: U.S. Government Accountability Office, *Freight Railroads: Industry Health Has Improved, But Concerns about Competition and Capacity Should be Addressed,* October 2006, p. 23.

Most of the previous examples involve rail-to-rail competition. The beneficial effect of competition is evident in those instances where water-to-rail competition exists, as shown in Figure VI-7.

Figure VI-7: Water-Rail Competition

Figure 11: Comparison of Rate Changes from Champaign, Illinois, Economic Area to New Orleans, Louisiana, Economic Area and Champaign, Illinois, Economic Area to Atlanta, Georgia, Economic Area, 1990-2004



Source: GAO analysis of STB data.

Source: U.S. Government Accountability Office, *Freight Railroads: Industry Health Has Improved, But Concerns about Competition and Capacity Should be Addressed*, October 2006, p. 24.

The experience in the past decade suggests that the presence of competition results in rates that are substantially lower. Captive shippers pay a premium 75 to 100 percent compared to similar movements in competitive markets and the cost of captivity has been rising substantially in the past half decade.

SERVICE QUALITY

The second area where we would expect to see performance effects of an imperfect market structure is in the realm of service quality. In one respect the negative effects of mergers were clear. The initial complaint about the mega-mergers of the 1990s focused on serious service quality problems that occurred when the huge new railroads had severe difficulty integrating their operations.

> The three mega-mergers of the 1990s have all been plagued with problems. It took BNSF much longer than expected to operationally merge the two railroads…
>
> By 1998, two economists estimated that the Union Pacific/Southern Pacific merger had already cost American shippers $2 billion.[68]
>
> As background, UNP, historically considered a service leader, has struggled to regain its former glory from a service and operational standpoint ever since the SP merger. However, the Unified Plan has now been in place for roughly two years (the general timeframe before we saw a step changed in operations from operating plans at other railroads), and we believe operations are showing significant progress.[69]

The service quality problem is not restricted to the post merger period. It is chronic. While there is no doubt that service quality improved after Staggers, it is also clear that current levels of quality leave a great deal to be desired.

> Rail on-time service is still rated poorly by shippers (relative to other modes). If there is an Achilles' heel to the pricing story, it is that rail service, which has improved from the terrible levels we witnessed following the mega-mergers in the 1990s, is still quite poor when compared to other freight transport modes. Parcel and truck service levels are perceived to be far better than what the rails deliver. In fact, CSX noted on its conference call with analysts that on-time performance has improved to 64% for the past 13 weeks. While this is up from the very poor 46% on-time arrivals for CSX's shipments in 1Q06, we would be hard-pressed to describe a service where 36% of shipments arrive late as "good.' By comparison, UPS and FedEx post on-time delivery metrics above 90% consistently.[70]
>
> The freight transport system is operating at full capacity for much of the year. Operating at capacity makes maintenance and expansion of the system difficult and leads to chronic delays in the shipment and receipt of goods. Freight rail capacity in the United States and Canada is limited and rail system performance is deteriorating… Despite poor performance, fuel surcharges and increased freight demand have allowed U.S. Class I railroads to continue to raise prices [71]
>
> Even under normal circumstances, it appears that railroads are not able to manage reliability well. While the timing and speed of trains are centrally controlled, the fact that most freight trains do not run a fixed schedule means

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[68] Larson and Spraggins 2000: 36) Larson, Paul, D. and H. Barry Spraggins. 2000. The American Railroad Industry: Twenty Years After Staggers. *Transportation Quarterly*. 5, p. 2.

[69] Morgan Stanley, 2007, p. 55.

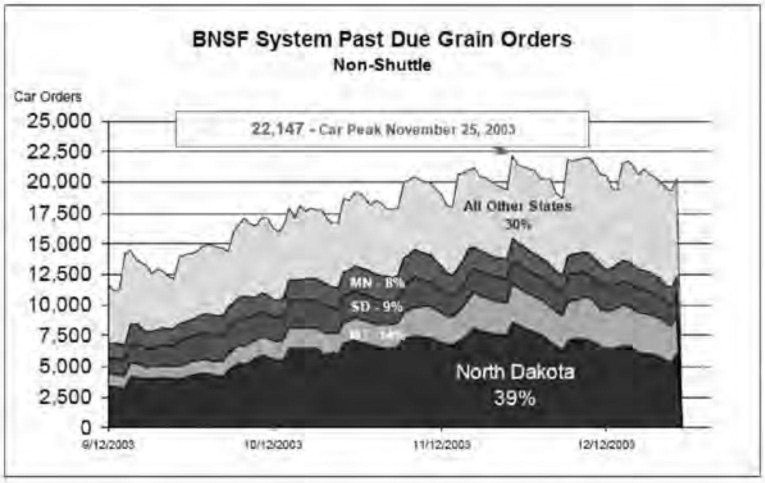
[70] Morgan Stanley, UPS, 2007, p. 15

[71] Ortiz, et al 2007: p. 2

that many shippers do not know when their freight will leave the terminal and arrive at its destination. Shippers have complained to STB about a general lack of reliability and that their freight sometimes gets lost.[72]

Shippers offer evidence that service quality problems are more likely to occur on captive traffic (see Figure VI-8).

Figure VII-8: Past Due Grain Orders



Source: "Testimony of Wayne Hurst, National Association of Wheat Growers" before the *House Committee on Transportation and Infrastructure, Hearing to Review Rail Competition and Service,* September 25, 2007, p. 3.

Poor service has an impact not only on the functioning of the railroads, but also on the broader economy. When capacity is inadequate, short lines and shippers are placed at a disadvantage and the economy suffers.

The last problem involving Class I carriers is that when their service levels are deficient, it affects short-line carriers. Thus, shippers become so frustrated that they stop shipping on rail and switch to truck. In some cases, this business is permanently lost to the rail industry. This was the situation immediately after the merger between the Union Pacific and the Southern Pacific. Other shippers contend that rail service is habitually sub-standard.[73]

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[72] Weatherford 2008, p. 33.

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[73] Johnson, et al. 2004. p. 1020.

VII. PROFITS, EXCESS PROFITS AND CROSS-SUBSIDIES

PROFITABILITY

While profitability is only one of the indicators of market performance, it receives and deserves a great deal of attention. In the rail sector it takes on particular importance because the issue of revenue adequacy was built into the statute and plays a key role in triggering regulatory protection for captive shippers. Throughout the Staggers era revenue adequacy has been highly controversial.

> The insistence by the ICC that virtually no railroads in the industry are revenue adequate, even though they are generating the billions of dollars in liquid assets to fund large acquisitions only reinforces our conviction that proper regulatory oversight is lacking. No single fact better underscores the failure of the ICC to properly execute its responsibility than the completely contradictory conclusion about the financial health of the railroads recently reached by the ICC and the Department of Transportation (DOT) (Cooper 1985a, p. 3).
>
> Railroads ought to be able to cover total operating expenses, to earn a reasonable return on their capital and to cover the costs of inflation to pay for new and old capital, as well as to provide a sound means of transportation for the nation. However, there is no economic rationale for allowing railroads to extract monopoly rents from captive shippers. By vastly overstating the revenue needs of railroads, the Commission has literally written the ticket that will allow the railroads to do just that. A proper evaluation of adequacy must be made which will distinguish between railroads which are truly inadequate and those which are simply deemed inadequate by a faulty definition.[74]

The dramatic rise in prices in the past half-decade was not driven by cost increases. As a result, the net income of the railroads has skyrocketed, more than doubling in a mere four years (see Figure VII-1). Return on invested capital has almost doubled over that period.

Earnings per share have increased even faster and Wall Street expects the trend to continue (see Figure VII-2). Through the first three quarters of 2008, "rail stocks are up 0.6% YTD on average, outperforming the broader S&P 500 Index by 3,225 basis points.[75]

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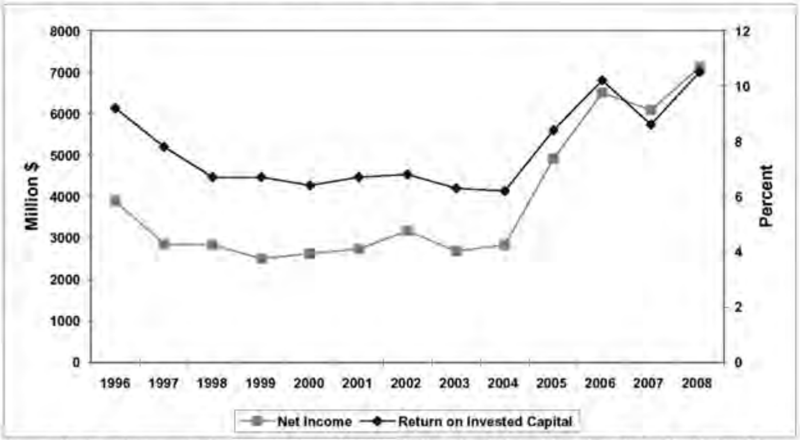
[74] Cooper, Mark. 1986. Railroad Antimonopoly Act of 1986. *Subcommittee on Commerce, Transportation and Tourism of the Energy and Commerce Committee*. U.S. House of Representatives. June 5., p. 4

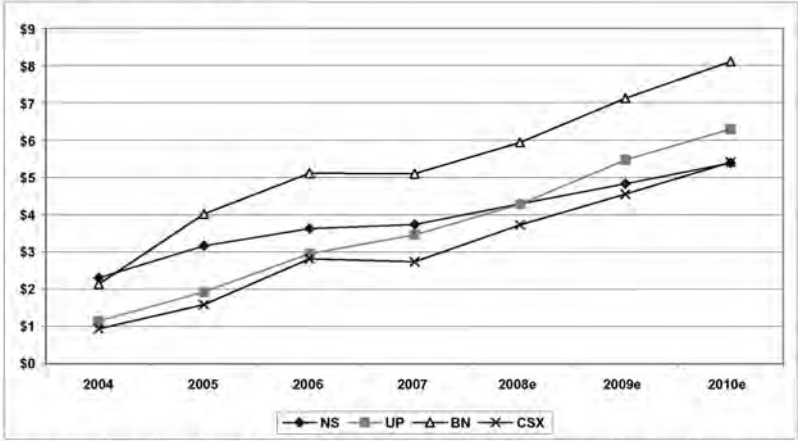
[75] Goldman Sachs. 2008, p. 1.

Figure VII-1: Net Income and Return on Investment



Source: Surface Transportation Board, *Class I Freight Railroads – Selected Earnings Data,* 2008 is last 12 months.

Figure VII-2: Earnings Per Share

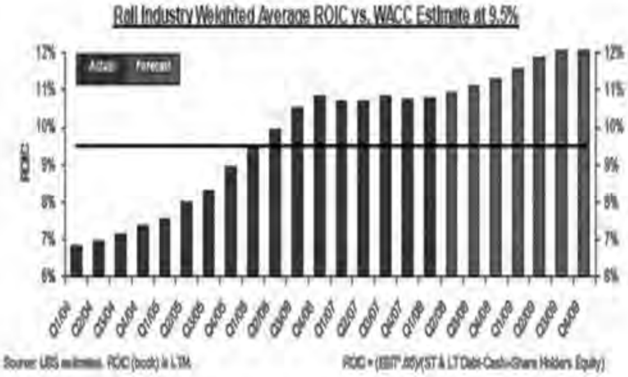


Source: Actual 2004-2007, Annual Reports; Estimated 2008-2010, Goldman Sachs, *Americas: Transportation: Railroads,* September 23, 2008

The dramatic improvement in profitability in the rail industry is obvious to knowledgeable observers. As Morgan Stanley noted "The outsized growth in railroad profitability over the past few years has given management less leverage in the current ongoing negotiations with labor.[79]

What goes on in the real world, however, bears little relationship to what goes on at the STB. In spite of the strong performance on Wall Street, the STB still concludes that the railroads are overwhelmingly revenue inadequate. The mistaken conclusions reached by the STB reflect the long-standing flaws in its approach. While the rails are deemed to be revenue inadequate at the STB, on Wall Street they are earning their cost of capital and then some, as shown in Figure VII-3.

Figure VII-3: Rail Industry Cost of Capital and Return on Investment



UBS, *Greasing the Wheels*, May 28, 2008, p. 3.

UBS predicted continuing increase in the railroad rate of return through 2008 based on the pricing power that the railroads enjoy, in spite of the weakening economy. We now know that the economy was in recession for the entire year. Notwithstanding the recession, as Figure VII-4 shows, the rail industry exceeded the UBS forecast. The increase in net income and return on investment was driven by price increases. Revenue ton-miles were up a meager .7 percent, but rail revenues were up 12 percent and net income was up by 20 percent. At the UBS weighted average cost of capital of 95 percent, all four the major railroads had a return on investment that exceeded the cost of capital, and six of the seven freight railroads did. The STB uses a higher figure for the revenue adequacy threshold, but even at the STB estimate two of the major freight railroads were at or above revenue adequacy. If the STB used a reasonable cost of capital, the excess profits in the rail industry would equal about $1 billion in 2008.

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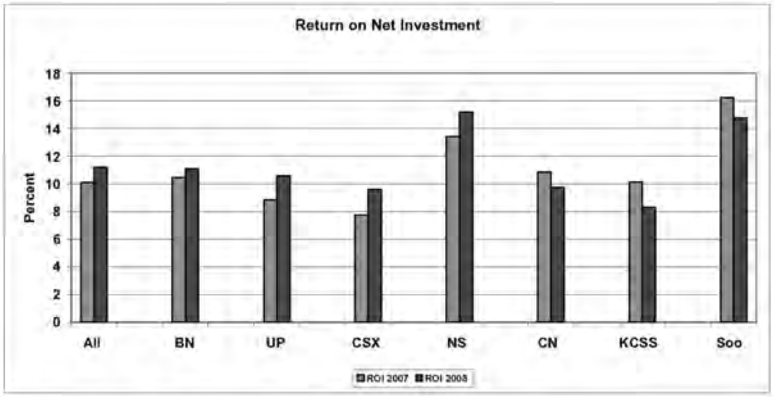
[79] Morgan Stanley, 2007, p. 15.

Figure VII-4: Return on Net Investment 2007-2008



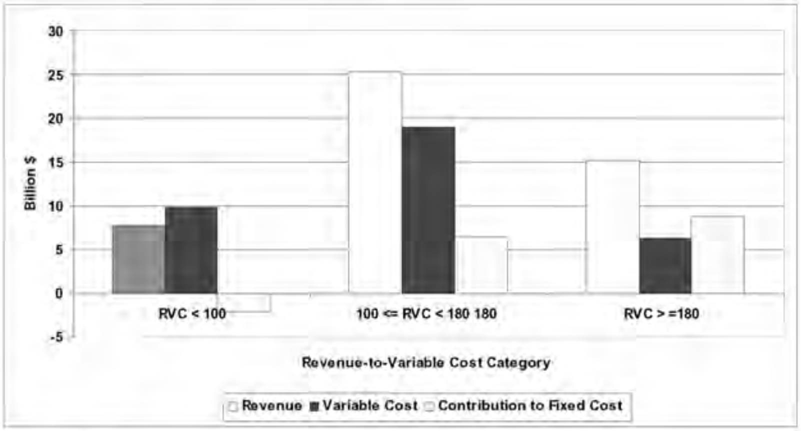
Surface Transportation Board, Class I Railroads – Selected Earnings Data.

REVENUE-TO-VARIABLE COST RATIOS

Embedded in these income and profitability numbers is an important and troubling aspect of rail traffic and revenues. It is remarkable to find that more than a quarter of a century after the passage of the Staggers Act over one-quarter of the traffic carried by the rails (as measured by variable cost) is non-compensatory. The most recent data, which are for 2005, show that 28 percent of the traffic carried by the freight railroads does not cover its variable costs (See Figure VII-5). The losses on this traffic equal $2.1 billion or 14 percent of the gains on the compensatory traffic. This is a very substantial drag on the bottom line.

The share of non-compensatory traffic is larger than the share of captive traffic (RVC > 180). Traffic above 180 percent is about 18 percent of the total (measured by cost). However, captive traffic accounts for about two-thirds of contributions to fixed costs (revenues above variable costs). Captive shippers represent less than one-fifth of total costs but provide two-thirds of the profit. The average revenue-to-variable cost ratio for captive traffic is 239 percent. Captive coal and chemicals traffic account for about 35% of all profits even though they account for only 14% of total revenues.

Figure VII-5: 2005 Revenue and Variable Costs



Source Surface Transportation Board, *Commodity Revenue Stratification Report* for 2005

If the drag on rail income caused by non-compensatory traffic were eliminated (either by raising rates to a compensatory level or shedding the traffic) and the reduction of that burden were used to alleviate the burden borne by captive traffic, the revenue-to-variable cost ratio on captive traffic would decline to 205 percent.

Estimating the impact of excessive returns is a more complex task. There are two major components of excessive returns, both subject to debate. How much should railroads earn is one major issue. A second issue is how assets should be divided between equity and debt. By relying on expensive equity, the railroads increase their cost of capital. Morgan Stanly believes that the railroads are under leveraged and can increase borrowing to buy back stock and increase shareholder value.

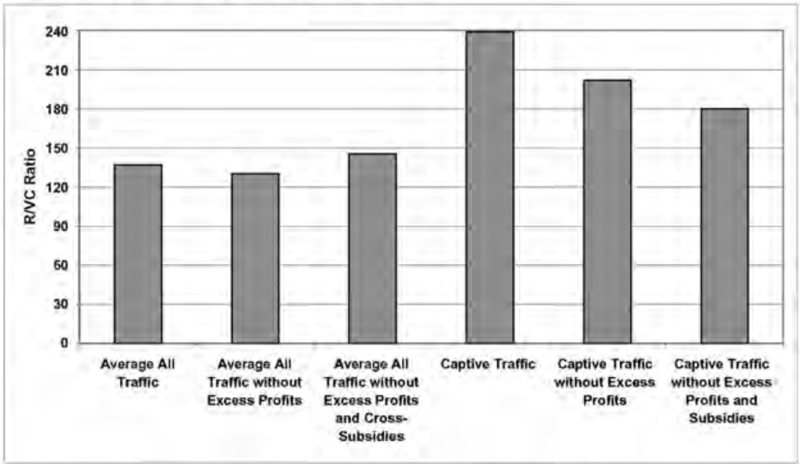
> For example, on an after tax basis, rails can borrow at roughly 4% today. Given our views that the pricing story is secular and durable for years, railroads that are disciplined in allocating capital to new projects should have plenty of balance sheet capacity to leverage up and buy back shares. If each of the rails issued debt to repurchase shares to the point where debt-to-total capital ratios equaled 60% (today they stand at 40-50%) in each of the next three years, we estimate that the companies could buy back 5-20% of their market capitalizations at today's prices. The implication of a buy-back of this

magnitude at today's prices is significant, especially if you believe such actions would lead to substantial multiple expansion.[77]

The UBS weighted average cost of capital is almost two percentage points lower than the STB calculated weighted-average cost of capital. For 2007, UBS shows rails exceeded their cost of capital by a full percentage point. Comparing the STB's return on net investment to the UBS cost of capital, the industry as a whole exceeded its cost of capital by 0.6 percent in 2007 and 1.7 percent in 2008. For 2008 this is more than $1 billion. Increasing the debt ratio as suggested by Morgan Stanley would lower the cost of capital by almost another percentage point, almost doubling the excessive returns. In total, the railroads would have over $2 billion in profit above their cost of capital.

If oversight of the industry were to eliminate excess profits and cross subsidies, the industry would be revenue adequate at a revenue-to-variable cost ratio of just under 150 percent (see Figure VII-6). The revenue-to-variable cost ratio on captive traffic would fall from just under 240 percent to 180 percent.

Figure VII-6: Revenue to Variable Cost Ratios



Source Surface Transportation Board, *Commodity Revenue Stratification Report* for 2005 for R/VC rations; excess profits calculated as achieved return minus CAPM cost of capital.

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[77] Morgan Stanley 2007, pp. 8-9, Morgan Stanley calculates the asset base and return on invested capital differently in arriving at the estimate of debt and equity.

VIII. CONCLUSION

This review of the state of the rail freight industry demonstrates that the mergers of the mid-1990s have created a highly concentrated market structure in which neither intramodal competitive forces within the rail sector nor intermodal competition from trucks and water transport is sufficient to discipline the abuse of market power. Anticompetitive conduct has further weakened competition by undermining interline traffic. The STB has done little, if anything, to prevent or diminish this abuse. With captive shipper rates and rail profits escalating rapidly the harm to consumers, shippers and the economy is mounting rapidly. The need to address this growing national problem is urgent.

The STB has failed to implement the captive shipper and procompetitive provisions of the Staggers Act to protect the public. We identified this central problem a quarter of a century ago. It has festered ever since and, as we have shown in the above analysis, now costs consumers billions of dollars per year.

> The captive shipper provisions in the Staggers Act were intended to ensure that the creation of a financially viable and economically sound rail network is achieved in an equitable and efficient manner. The Act identifies revenue adequacy as a primary goal and allows differential pricing – price discrimination – in pursuit of that goal. However, neither the revenue adequacy principle no differential pricing was intended to be a blank check. Congress expected that some price discrimination would exist in the railroad industry by setting a high jurisdictional threshold, but it also intended to restrain price discrimination.
>
> It allowed for flexible jurisdictional thresholds.
>
> It stipulated that management had to be honest, economic and efficient.
>
> It required the maximization of revenues from competitive traffic.
>
> It stated that even in the quest for revenue adequacy the burden placed on captive commodities, such as coal, should not be onerous (Cooper 1986, p. 9).

Section 203 of the Staggers Act, the "Long-Cannon Amendment, the essential compromise that led to the passage of the Staggers Act in 1980, states that...

> (c) In determining whether a rate is reasonable, the Commission shall consider, among other factors, evidence of the following:
>
> (i) the amount of traffic which is transported at revenues which do not contribute to going concern value and efforts made to minimize such traffic:

(ii) the amount of traffic which contributes only marginally to fixed costs and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic; and

(iii) The carrier's mix of rail traffic to determine whether one commodity is paying an unreasonable share of the carrier's overall revenues.

Unfortunately, the ICC has robbed consumers of these protections by ignoring their provisions and abusing its discretionary authority under the Act. Instead of balancing the interests of railroads and consumers, the ICC has decided virtually every issue in favor of the railroads, creating an environment in which regulation no longer restrains monopoly power. Under current administrative procedure the ICC has built such a massive regulatory framework and publicly embraced such a strident economic theory that it is virtually impossible for maximum rate regulation to be changed without congressional action (Cooper 1985a, p. 5).

As outlined in the policy recommendations section in the Introduction, Congress should address three broad areas.

First, it should restore antitrust oversight over the rails.

Second, it should reform the regulation of captive shipper rates by mandating captive shipper thresholds be set at a RVC ratio of 180 with cost plus a reasonable rate of return as the guiding principle and rate of return set by the CAPM model; shifting the burden to the railroads and reforming the small shipper complaint methodology.

Third, it should ensure the STB has the resources and manpower to effectively implement these captive ratepayer protections.